Simplification for Low-Income Taxpayers: Some Options

JONATHAN BARRY FORMAN*

"[T]he present tax law has spun out complications to the extent that it is truly monstrous. In my view, something must be done about it."

The Honorable Erwin N. Griswold, February 5, 1993.[1]

I. INTRODUCTION

According to the Census Bureau, more than 39 million Americans live in poverty.[2] Relatively few of these low-income individuals have a net federal tax

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* Copyright 1996, Jonathan Barry Forman. Professor of Law, University of Oklahoma; B.A. 1973, Northwestern University; M.A. (Psychology) 1975, University of Iowa; J.D. 1978, University of Michigan; M.A. (Economics) 1983, George Washington University. The author wishes to thank Jerome Borison, George K. Yin, James B. Lewis, Mary L. Heen, Victor Thuronyi, Thomas G. Collins, J. E. McNeil, Jeffrey S. Gold, William J. Turnier, Peter A. Slowiaczek, Paul Heimer, Cynthia G. Lepow, Andrew W. Singer, Natwar M. Gandhi, Janet Holtzblatt, and J. Paul Whitehead, III, for their helpful comments on earlier drafts. Research assistance was provided by Kelly Trost-Walker and Janae D. Walker.

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[1] Erwin N. Griswold, *Is the Tax Law Going to Seed?,* 11 AM. J. TAX POL'Y 1, 9 (1994) (remarks before the annual meeting of the American College of Tax Counsel).

[2] *Number of Elderly Poor Drops: 'Statistical Anomaly' Cited for Part of the Drop,* SUNDAY OKLAHOMAN, Dec. 11, 1994, at A24. The Census Bureau estimated the total U.S. population at 259.2 million and the overall poverty rate at 15.1%. *Id.*

liability at the end of the year.[3] Nevertheless, the current federal tax system requires virtually all low-income individuals to file income tax returns, if only to recover refunds of their over-withheld taxes.[4] Moreover, recent changes in the federal tax system—particularly the repeated expansion of the earned income credit[5]—have made the federal tax system significantly more complicated for low-income individuals and for the Internal Revenue Service (IRS).

What can be done to simplify the federal tax system for low-income individuals and for the IRS? This Article tries to answer that question. In particular, this Article identifies a variety of possible statutory and regulatory changes that would: (1) reduce the number of low-income taxpayers required to file tax returns; and (2) simplify the return-filing process for those low-income taxpayers who must file returns. The options considered here range from merely simplifying income tax returns to completely revamping the federal tax system.

Part II of this Article explains the current federal tax treatment of low-income individuals. Part III of this Article then discusses the impact of the current system on low-income individuals. At the outset, Part III shows that millions of low-income individuals currently have no net federal tax liability. Next, Part III shows that, even though few low-income individuals have net federal tax liabilities, most must file income tax returns, if only to recover their over-withheld taxes and excess earned income credits. Finally, Part III

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[3] In this Article, the term "individuals" is used to refer to all types of individuals and families who might pay taxes, not just "unmarried individuals" as the term is used in I.R.C. § 1(c) (1994).

While an absolute definition of "low-income individual" is not needed for purposes of this Article, certainly any individual or family whose income is below the U.S. Department of Health and Human Services poverty income guidelines should be thought of as "low-income." *See* Annual Update of the Poverty Income Guidelines, 60 Fed. Reg. 7,772 (1995) [hereinafter Poverty Income Guidelines]. The most recent poverty income guidelines are set forth in Table 1 of the text, *infra*.

The poverty income guidelines are a simplified version of the federal government's statistical poverty thresholds used by the U.S. Department of Commerce, Bureau of the Census, to prepare statistical estimates of the number of persons and families in poverty. Each year, the poverty income guidelines are updated to reflect the prior year's change in the Consumer Price Index. The poverty income guidelines are used as eligibility criteria by a number of social welfare programs.

[4] Simply stated, most low-income individuals will see the earned income tax credit more than offset their income and Social Security tax liabilities.

[5] I.R.C. § 32 (1994). The credit was expanded in 1978, 1980, 1984, 1986, 1990, and 1993. *See, e.g.*, Michael J. Caballero, *The Earned Income Tax Credit: The Poverty Program That is Too Popular*, 48 TAX LAW 435, 435 n.2, 437–56 (1995).

discusses some of the IRS's recent efforts to simplify the tax system for low-income individuals.

Part IV of this Article explores various approaches to simplification of the tax system for low-income individuals. Part IV first focuses on the need for simplification and the direction for change. Part IV then considers some statutory and regulatory changes that would simplify current income tax returns and the current return-filing process. Finally, Part IV considers the impact of more fundamental changes to the current federal tax system, such as: (1) integrating the income and Social Security taxes; (2) shifting to a flat tax, perhaps with a consumption tax base; and (3) moving to a return-free system.

II. CURRENT FEDERAL TAX TREATMENT OF LOW-INCOME INDIVIDUALS

The principal federal taxes affecting low-income individuals are the individual income tax, Social Security taxes, and excise taxes. These are explained in turn.

A. *The Individual Income Tax*

1. *Overview of the Individual Income Tax*

The federal income tax is imposed on a taxpayer's taxable income.[6] In general, the taxable income of a low-income individual is equal to the individual's adjusted gross income[7] less a standard deduction and personal exemptions.[8] A low-income individual's preliminary tax liability (if any) is equal to 15% of taxable income.[9] The amount that the individual must pay with the return or, alternatively, the amount of the refund, is equal to the individual's preliminary tax liability minus allowable credits. Other than the

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[6] I.R.C. § 1 (1994).

[7] I.R.C. § 62 (1994). A taxpayer's "adjusted gross income" is defined as equal to the taxpayer's "gross income" less certain deductions. I.R.C. § 61 defines a taxpayer's "gross income" as "all income from whatever source derived" by the taxpayer during the taxable year, including but not limited to wages, salary, tips, dividends, interest, rents, and royalties. Because few of the allowable deductions under I.R.C. § 62 are likely to be claimed by low-income taxpayers, in most cases a low-income taxpayer's adjusted gross income will be exactly equal to her gross income.

[8] I.R.C. §§ 63, 151 (1994).

[9] I.R.C. § 1 (1994). Of course, 28, 31, 36, and 39.6% tax rates can apply to taxpayers with higher incomes. *Id.*

credit for withheld income taxes,[10] the principal credits used by low-income individuals are the dependent care credit[11] and the earned income credit.[12]

Each year, the U.S. Department of Treasury indexes the standard deduction amounts, the personal exemption amounts, the earned income credit, and the income tax rate tables to reflect the prior year's change in the Consumer Price Index.[13] For 1996, the basic standard deduction amounts are: $6,700 for married couples filing jointly and for surviving spouses; $5,900 for heads of households; $4,000 for unmarried individuals; and $3,350 for married individuals filing separately. Aged or blind individuals generally are entitled to claim an additional standard deduction amount of $800, except that aged or blind unmarried individuals can claim an additional standard deduction amount of $1,000.[14]

The personal exemption amount for 1996 is $2,550. The rate tables have also been modified so that, for 1996, the 15% marginal tax rate extends to all

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[10] I.R.C. § 31 (1994).

[11] I.R.C. § 21 (1994). The dependent care credit is a nonrefundable credit for up to 30% of a limited amount of employment-related dependent care expenses incurred by an individual who maintains a household that includes one or more qualifying individuals. Generally, a qualifying individual is a dependent under age 13 or a physically or mentally incapacitated dependent or spouse. The maximum 30% credit rate is "reduced (but not below 20%) by 1 percentage point for each $2,000 (or fraction thereof)" of adjusted gross income above $10,000. *Id.* Eligible employment-related expenses are limited to $2,400 if there is one qualifying individual (maximum credit $720 = 30% x $2,400), or $4,800 if there are two or more qualifying individuals (maximum credit $1,440 = 30% x $4,800). *Id.*

[12] I.R.C. § 32 (1994). The earned income credit is a refundable credit available to certain low- and moderate-income workers. In 1996, childless workers are entitled to an earned income credit of up to $323; workers with one qualifying child are entitled to a credit of up to $2,152; and workers with two or more qualifying children are entitled to a credit of up to $3,556. Rev. Proc. 95-53, 1995-52 I.R.B. 22, 23–24.

The earned income credit was originally enacted in 1975, and over the years it has grown to be one of the principal antipoverty programs in the federal budget. The credit was most recently expanded by the Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, 107 Stat. 312 (1993). In 1995, some 18 million taxpayers were expected to claim more than $22 billion of earned income credits, with an average credit per taxpayer of more than $1,200 per year, and when the expansion of the credit is completed in 1996, almost 19 million taxpayers are expected to claim the credit, at a total cost of $25 billion. STAFF OF HOUSE COMM. ON WAYS AND MEANS, 103D CONG., 2D SESS., OVERVIEW OF ENTITLEMENT PROGRAMS: 1994 GREEN BOOK: BACKGROUND MATERIAL AND DATA ON PROGRAMS WITHIN THE JURISDICTION OF THE COMMITTEE ON WAYS AND MEANS 702–04 (Comm. Print 1994) [hereinafter GREEN BOOK].

[13] *See, e.g.*, Rev. Proc. 95-53, *supra* note 12, at 22.

[14] *Id.* at 24.

taxable incomes up to $40,100 for married couples filing jointly and for surviving spouses; $32,150 for heads of households; $24,000 for unmarried individuals; and $20,050 for married individuals filing separately. For taxable incomes above those amounts, marginal tax rates of 28, 31, 36, and 39.6% are applicable.[15]

The maximum earned income credit amounts for 1996 have also been increased. Individuals with one qualifying child are entitled to an earned income credit of up to $2,152.[16] Individuals with two or more qualifying children are entitled to an earned income credit of up to $3,556.[17] Individuals without children are entitled to an earned income credit of up to $323;[18] however, it should be noted that childless individuals who are under age 25 or over age 64 are not eligible for any earned income credit.[19] All in all, the individual income tax raises about $600 billion a year for the federal government.[20]

2. *Returns and Paperwork*

Individuals file income tax returns as married couples filing joint returns (and surviving spouses), as heads of household, as unmarried individuals, or as married individuals filing separately. More than 117 million individual income tax returns are expected to be filed for the 1995 tax year.[21] In that regard, of the roughly 115 million returns filed in 1994, some 68 million were on Form 1040, 23 million on Form 1040A, and 19 million on Form 1040EZ.[22]

Typically, about 70% of individuals claim the standard deduction in lieu of itemizing their deductions. For example, for 1993, roughly 81 million

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[15] *Id.* at 23.

[16] *Id.* at 23-24. The credit is computed as 34% of the first $6,330 of earned income. The maximum credit is reduced by 15.98% of earned income (or adjusted gross income, if greater) in excess of $11,610 and is entirely phased out at $25,078 of income. *Id.*

[17] *Id.* The credit is computed as 40% of the first $8,890 of earned income. The maximum credit is reduced by 21.06% of earned income (or adjusted gross income, if greater) in excess of $11,610 and is entirely phased out at $28,495 of income. *Id.*

[18] *Id.* The credit is computed as 7.65% of the first $4,220 of earned income. The maximum credit is reduced by 7.65% of earned income (or adjusted gross income, if greater) in excess of $5,280 and is entirely phased out at $9,500 of income. *Id.*

[19] I.R.C. § 32(c)(1)(A)(ii)(II) (1994).

[20] For fiscal year 1995, individual income taxes are expected to raise $595.9 billion. GREEN BOOK, *supra* note 12, at 1259.

[21] Internal Revenue Service, *Selected Historical and Other Data*, 15 SOI BULL. 141, 217 (Fall 1995) [hereinafter *Selected IRS Data*].

[22] Internal Revenue Service, *Selected Historical and Other Data*, 14 SOI BULL. 139, 189 (Fall 1994). In addition, the IRS processed about 4 million Form 1040PC returns. *Id.*

individuals claimed the standard deduction, and the remaining 33 million itemized their deductions.[23] On the other hand, an even greater percentage of low-income individuals claim the standard deduction. For example, more than 90% of taxpayers with adjusted gross income of $30,000 or less claimed the standard deduction in 1993.[24]

Also, many low-income individuals claim the earned income credit. To claim the earned income credit, an individual must file a tax return and individuals with children must attach Form EIC. For 1993, over 15.3 million families claimed the credit.[25]

Most individuals who file returns get refunds from the IRS. For example, of the 114.6 million income tax returns filed for 1993, 28.6 million showed tax due at the time of filing, 82.4 million showed an overpayment, and 3.6 million showed neither an overpayment nor a tax due at the time of filing.[26] All in all, the tax due at the time of filing was $50.3 billion and the amount of overpayments was $98.9 billion of which $84.8 billion was refunded.[27]

B. *Social Security Taxes*

Social Security taxes are levied on earnings in employment and self-employment covered by Social Security, with portions of the total tax allocated by law to the Old-Age and Survivors Insurance trust fund ("OASI"), the Disability Insurance trust fund ("DI"), and the Medicare Hospital Insurance trust fund ("HI").[28] For 1996, employees pay Social Security taxes of 7.65% of the first $62,700 of wages and 1.45% of wages over $62,700.[29] Employers pay a matching Social Security tax of 7.65% of up to $62,700 of wages of each covered employee and 1.45% of wages over $62,700.[30] Similarly, self-

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[23] *Selected IRS Data*, *supra* note 21, at 202.

[24] Author's computations from *id.* at 144.

[25] *Id.* For 1996, almost 19 million low-income families are expected to claim the earned income credit. GREEN BOOK, *supra* note 12, at 704.

[26] *Id.* at 204.

[27] *Id.* at 143.

[28] I.R.C. §§ 1401, 3101, 3111 (1994).

[29] 1996 Cost-of-Living Increase and Other Determinations, 60 Fed. Reg. 54,751, 54,753-54 (1995) [hereinafter Social Security COLA].

[30] *Id.* Most economists believe that the burden of both the employee's and the employer's portion of Social Security taxes falls on the employee. The lower take-home pay as a result of the tax is not expected to reduce the number of workers seeking jobs, nor does the tax increase worker productivity. Accordingly, employers have no reason to pay higher total compensation, so the burden of the tax is borne by workers. *See, e.g.*, JOSEPH A. PECHMAN, FEDERAL TAX POLICY 223-25 (5th ed. 1987).

employed workers pay an equivalent Social Security tax of 15.3% up to $62,700 of net earnings from covered self-employment and 2.9% of net earnings over $62,700.[31] In 1992, for example, almost 118 million civilian workers were subject to Social Security taxes,[32] and the federal government collected roughly $390 billion in Social Security taxes.[33]

C. *Excise Taxes*

Federal excise taxes are levied on the sale, consumption or manufacture of certain items. In the federal government's fiscal year 1995, excise taxes raised about $56 billion in revenue.[34] The principal federal excise taxes affecting low-income families are alcohol taxes (e.g., $13.50 per proof gallon of distilled spirits), tobacco taxes (e.g., 24 cents per pack of cigarettes), highway and rail taxes (e.g., 14 cents per gallon of gasoline), and telephone excise taxes (e.g., 3% of local and long distance calls).[35] Indeed, these taxes alone raised more than $35 billion in fiscal year 1995.

III. THE IMPACT OF FEDERAL TAXES ON LOW-INCOME INDIVIDUALS

This Part considers the extent to which low-income individuals are required to pay federal taxes. Subpart A shows that millions of low-income individuals currently have no net federal tax liability. Subpart B shows that

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On this view low-income employees face Social Security taxes equal to roughly 15.3% of their wages (15.3% = 2 x 7.65%). The effective marginal tax rate is actually slightly lower than 15.3% of income, as a discount should be applied to take into account the fact that only the employee portion of the Social Security tax is included in the employee's income for income tax purposes—the employer portion is excluded from income.

Low-income taxpayers are also thought to bear the burden of unemployment compensation taxes and workers' compensation taxes paid by their employers; however, these taxes are relatively small and, in any event, simply beyond the scope of this Article. *See, e.g.*, GREEN BOOK, *supra* note 12, at 263–303 (unemployment taxes and benefits); *id.* at 847–50 (workers' compensation).

[31] Social Security COLA, *supra* note 29, at 54,753–54.

[32] GREEN BOOK, *supra* note 12, at 80.

[33] Social Security Administration, ANNUAL STATISTICAL SUPPLEMENT TO THE SOCIAL SECURITY BULLETIN 163, 307 (1994) (summing $311 billion in Old Age and Survivors Insurance and Disability Insurance taxes and $82 billion in Medicare taxes); *see also* GREEN BOOK, *supra* note 12, at 1259 (Social insurance taxes are expected to raise $499.3 billion in fiscal year 1995.).

[34] GREEN BOOK, *supra* note 12, at 1258.

[35] *See generally* STAFF OF THE JOINT COMM. ON TAXATION, 103D CONG., 2D SESS., SCHEDULE OF CURRENT FEDERAL EXCISE TAXES (Comm. Print 1994).

most low-income individuals must nevertheless file income tax returns in order to recover their over-withheld taxes. Finally, Subpart C discusses some of the IRS's recent efforts to simplify the tax system for low-income individuals.

A. *Net Federal Tax Liabilities of Low-Income Individuals*

Because of standard deductions, personal exemptions, and the earned income credit, relatively few low-income individuals pay any income taxes. On the other hand, because the Social Security tax system has no standard deductions or personal exemptions, many individuals earning less than the poverty level are required to pay Social Security taxes.[36] Low-income individuals also pay excise taxes, for example on their purchases of gasoline, alcohol, and tobacco.

The earned income credit offsets the Social Security and excise tax liabilities of most low-income individuals. Nevertheless, some low-income individuals do have net federal tax liabilities. This Subpart explores the net tax liabilities of low-income individuals.

At the outset, however, it must be noted that the analysis in this Subpart largely ignores the impact of federal excise taxes on low-income individuals. There are two reasons for this. First, the impact of federal excise taxes on low-income individuals is small: income taxes and Social Security taxes are the big taxes on individuals. Second, it would be extremely difficult to allocate the impact of particular excise taxes to particular low-income individuals.

1. *Tax Thresholds and Poverty Levels*

This Section explores the impact of income and Social Security taxes on individuals with incomes at or below the U.S. Department of Health and Human Service's poverty income guidelines.[37] Basically, this Section shows that many low-income individuals had no net federal tax liability in 1995.

At the outset, Table 1 shows the 1995 federal tax liabilities of various family units with earnings exactly equal to their poverty levels.[38] Basically,

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[36] Moreover, of those low-income families paying any federal taxes, over 97% pay more Social Security taxes than income taxes. *See* STAFF OF HOUSE COMM. ON WAYS AND MEANS, 103D CONG., 1ST SESS., OVERVIEW OF ENTITLEMENT PROGRAMS: 1993 GREEN BOOK: BACKGROUND MATERIAL AND DATA ON PROGRAMS WITHIN THE JURISDICTION OF THE COMMITTEE ON WAYS AND MEANS 1544 (Comm. Print 1993).

[37] Poverty Income Guidelines, *supra* note 3.

[38] The table reflects assumptions that all family income consists of wages or salaries earned by a single worker, that families of two or more include a married couple (rather than an unmarried head of household with one or more dependents), that all family

Table 1 shows that poverty-level married couples with one, two, or three children actually receive net subsidies via refunds from the federal tax system. On the other hand, smaller and larger poverty-level family units have at least a small net federal tax liability.[39]

TABLE 1. FEDERAL TAXES AT THE POVERTY LEVELS IN 1995, BY FAMILY SIZE[40]

[dollars]

Family size

ROW	1	2	3	4	5	6
1. Poverty Levels:	7,470	10,030	12,590	15,150	17,710	20,270
2. Income tax at Poverty Level (after earned income credit):	26	0	-1,886	-2,330	-1,812	-1,294
3. Social Security Tax at poverty level:	571	767	963	1,159	1,355	1,551
4. Combined income and Social Security Tax at poverty level:	597	767	-923	-1,171	-457	257
5. Combined tax as percent of income at poverty level:	8.0	7.6	-7.4	-7.7	-2.6	1.3

Source: Poverty Income Guidelines, *supra* note 3, at 7,772 and author's computations.

Consider a family of four consisting of a married couple with two children. Row 1 shows that the couple's poverty income guideline in 1995 was $15,150.[41] Assuming that the couple had exactly that much earned income, after taking into account its earned income credit, Row 2 shows that the couple

members are under age 65 and not blind, and that all family units are eligible for the earned income credit (for example, childless workers are between the ages of 25 and 65). Also, only the employee's portion of Social Security taxes is considered.

39 Of note, an analysis of family units headed by unmarried individuals would show similar results. Also, childless individuals and couples who are under age 25 or over age 64 would have somewhat greater income and net tax liabilities than shown in Table 1, as the earned income credit is not available to them. I.R.C. § 32(c)(1)(A)(ii)(II) (Supp. V 1993).

40 *See supra* note 38 for assumptions underlying these calculations.

41 The poverty income guidelines used in this Article are those applicable to all states (except Alaska and Hawaii) and the District of Columbia. Somewhat higher poverty income guidelines are applicable to Alaska and Hawaii. *See* Poverty Income Guidelines, *supra* note 3.

is entitled to an income tax refund of $2,330.[42] Row 3 shows that the couple's Social Security tax liability is $1,159.[43] As the couple's income tax refund in Row 2 is greater than its Social Security tax liability in Row 3, the couple is entitled to receive a net refund of $1,171 from the federal government, as shown in Row 4.[44] Finally, Row 5 expresses the couple's net tax liability as a percent of income: this couple has a net tax liability equal to -7.7% of its poverty level income.[45]

Next, Table 2 compares the combined income and Social Security tax thresholds (i.e., net federal tax thresholds) of various family units with their poverty income guidelines.[46] Basically, Table 2 shows that married couples with one, two, or three children have net federal tax thresholds that are slightly above their poverty income guidelines. On the other hand, the smaller and larger family units shown have net federal tax thresholds that are somewhat below their poverty income guidelines.[47]

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[42] As more fully explained in connection with Table 2, *infra*, the couple was entitled to a standard deduction of $6,550 for a married couple filing jointly and four $2,500 personal exemptions for a simple income tax threshold in 1995 of $16,550. As the couple's taxable income was $0 ($15,150 earned income < $16,550 simple income tax threshold) its preliminary income tax liability will be $0 ($0 = 15% tax rate x $0 taxable income). Because of the earned income tax credit, however, the couple is entitled to a tax refund of about $2,330 ($2,329.51 = $3,110 [maximum credit for a taxpayer with two children] - .2022 x ($15,150 - $11,290) [phase-out formula]).

[43] $1,159 = .0765 x $15,150. Again, only the employee's portion of Social Security taxes is considered in this table.

[44] -$1,171 = $1,159 - $2,330.

[45] -7.7% = -$1,171 / $15,150.

[46] This table reflects the same assumptions as in Table 1. *See supra* note 38.

[47] Again, an analysis of family units headed by unmarried individuals would show similar results. Also, childless individuals and couples who are under age 25 or over age 64 would have lower income and net tax thresholds than shown in Table 2, as the earned income credit is not available to them. I.R.C. § 32(c)(1)(A)(ii)(II) (Supp. V 1993).

TABLE 2. NET FEDERAL TAX THRESHOLDS AND POVERTY LEVELS IN 1995, BY FAMILY SIZE [48]
[in dollars]

	Family size					
ROW	1	2	3	4	5	6
1. Poverty Levels:	7,470	10,030	12,590	15,150	17,710	20,270
2. Simple income tax threshold (before earned income credit):	6,400	11,550	14,050	16,550	19,050	21,550
3. Income tax threshold after earned income credit:	7,357	11,550	19,386	22,360	23,425	24,490
4. Social Security tax threshold:	0	0	0	0	0	0
5. Combined income and Social Security tax threshold:	4,100	4,100	15,547	18,370	19,245	19,350

Source: Poverty Income Guidelines, *supra* note 3, at 7,772 and author's computations.

Again, consider a family of four consisting of a married couple and two children. Row 1 shows that the couple's poverty income guideline in 1995 was $15,150. Row 2 shows the simple income tax thresholds for family units of different sizes. These are determined by summing each family unit's standard deduction and its personal exemptions. In 1995, a married couple with two children could file a joint tax return and claim a $6,550 standard deduction and four $2,500 personal exemptions.[49] Consequently, the couple did not have to pay any income tax until its income exceeded its $16,550 simple income tax threshold.[50]

Row 3 of the table shows each family unit's income tax threshold after taking into account the effect of the earned income credit. The earned income credit is a part of the income tax system which can offset a family unit's preliminary income tax liability. Consequently, taking the earned income credit into account raises the income tax threshold for some family units. For example, taking into account the earned income credit, a typical married couple

48 *See supra* note 38 for assumptions underlying these calculations.

49 Rev. Proc. 94-72, 1994-2 C.B. 811, 813–14..

50 $16,550 = $6,550 + (4 x $2,500).

with two children does not actually owe any income tax for 1995 until its income exceeded $22,360.[51]

On the other hand, because the Social Security tax system has no standard deductions or personal exemptions, family units must pay Social Security taxes starting with their first dollar of earned income. Hence, Row 4 shows that zero is the Social Security tax threshold for all family units.

Row 5 then shows the combined income and Social Security tax thresholds (i.e., net federal tax thresholds) for various family units.[52] Because the earned income credit is refundable, it can offset not only individual income taxes, but also Social Security taxes. Consequently, a family unit will have no net federal tax liability until the sum of its income tax and Social Security tax liabilities exceeds its earned income credit (if any). For example, a typical married couple with two children does not actually have a net tax liability for 1995 unless its income exceeded $18,370.[53]

To summarize, Tables 1 and 2 show that many (if not most) low-income individuals do not have a net federal tax liability for 1995. In particular, low-income married couples with one, two, or three children will generally receive net subsidies via refunds from the federal tax system.[54] For example, a married couple with two children which had wages equal to its $15,150 poverty level

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[51] Algebraically, each computation in Table 2 involved determining the appropriate equation for computing each family unit's income tax liability after its earned income credit and solving for the income level at which that tax liability is equal to zero.

For example, for 1995, for a married couple with two children with income (I) in excess of its $16,550 simple income tax threshold but less than the $26,673 level at which the earned income credit was fully phased out, the couple's income tax liability (T) can be determined by the following formula:

$T = .15 \times (I - \$16,550) - (\$3,110 - .2022\ [I - \$11,290])$.

Setting T equal to zero and solving for I shows that the couple's income tax threshold after the earned income credit in 1995 was $22,360.

[52] Again, only the employee's portion of Social Security taxes is considered in this table, and excise taxes are ignored.

[53] Algebraically, each computation involved determining the appropriate equation for computing each family unit's combined income and Social Security tax liability after its earned income credit and solving for the income level at which that tax liability is equal to zero.

For example, for 1995, for a married couple with two children with income (I) in excess of its $16,550 simple income tax threshold but less than the $26,673 level at which the earned income credit was fully phased out, the couple's combined income and Social Security tax liability (T) can be determined by the following formula:

$T = .15 \times (I - \$16,550) + .0765 \times I - (\$3,110 - .2022\ [I - \$11,290])$.

Setting T equal to zero and solving for I shows that the couple's combined income and Social Security tax threshold after the earned income credit in 1995, was $18,369.68.

[54] Only those with nonwage income could possibly owe any tax.

and no other income will collect a net tax refund of $1,171 for 1995. Similarly, many low-income childless individuals, childless couples, and large families will also be entitled to refunds for 1995.

On the other hand, some low-income childless individuals, childless couples, and large families do have net federal tax liabilities for 1995. For example, a married couple with four children that earned more than $19,350 does have a net federal tax liability for 1995.[55] Also, a married couple with four children and a poverty-level income of $20,270 has a net federal tax liability of $257.[56] Similarly, a childless individual who is eligible to claim the earned income credit has a net federal tax liability if she earns more than $4,100, and she will have a net federal tax liability of $597 if she earns a poverty-level income of $7,470.[57]

Also, an analysis of family units headed by unmarried individuals (i.e., heads of household) would show results similar to those in Tables 1 and 2. For example, consider a single parent with two children and income equal to the poverty level. She owes no federal taxes for 1995 unless she earned more than $17,216. Basically, her $5,750 standard deduction and three $2,500 personal exemptions together sheltered $13,250 from the income tax in 1995, and her earned income credit offset the rest of her income and Social Security tax liability. Moreover, a single parent with two children and a poverty-level income of $12,590 will receve a net federal transfer of $1,884.[58]

On the other hand, an analysis of low-income childless individuals and couples who are ineligible for the earned income credit (i.e., because they are under age 25 or over age 64) would show slightly greater tax liabilities at every income level. For example, for 1995, a 21 year-old childless individual owed Social Security taxes from the very first dollar of earned income; she owed income taxes once her earnings exceeded her $6,400 simple income tax threshold; and she has a net federal tax liability of $732 if she earned a poverty-level income of $7,470.[59]

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[55] *See* Table 2, at row 5, column 6.

[56] *See* Table 1, at row 4, column 6.

[57] *See* Table 2, at row 5, column 1; Table 1, at row 4, column 1.

[58] As her $12,590 poverty-level income was below her $13,250 simple income tax threshold, she has no preliminary federal income tax liability. She owes $963 in Social Security taxes ($963 = 7.65 percent x $12,590), but her $2,847 earned income credit more than offsets her Social Security tax liability ($2,847 = $3,110 - .2022 [$12,590 - $11,290]). Consequently, she should get a net refund of $1,884 (-$1,884 = $963 - $2,847).

[59] $732 = $161 in income tax ($160.50 = .15 x [$7,470 - $6,400]) plus $571 in Social Security tax ($571.46 = .0765 x $7,470).

2. *Tax Calculations for a Variety of Hypothetical Taxpayers*

This Section considers the average and effective marginal tax rates imposed on individuals with varying levels of wage and nonwage income. At the outset, Table 3 presents some examples of individual income and Social Security tax liabilities for a variety of hypothetical taxpayers with varying levels of income for the representative year 1994.[60] Table 3 also shows the total tax liability, the average tax rate, and the marginal tax rate for each of those hypothetical taxpayers.

Table 4 shows the effective marginal tax rates for an even broader range of taxpayers for 1995.[61] Together, Tables 3 and 4 again show that many low-income families with children have no net federal tax liabilities. Instead, because of the earned income credit, many low-income families with children are entitled to subsidies from the federal government. Tables 3 and 4 also show that even low-income individuals without children have relatively low net federal tax liabilities, most of which are attributable to their Social Security tax liabilities.

[60] GREEN BOOK, *supra* note 12, at 720. Unlike Tables 1 and 2, this table reflects the assumption that each worker bears both the employer and employee shares of Social Security. This table also reflects assumptions that eligible individuals claimed the earned income credit and that individuals claimed the standard deduction. Also, income sources are listed in the table's footnotes for each example.

[61] *Id.* at 725–28.

TABLE 3. EXAMPLES OF FEDERAL INCOME AND PAYROLL TAX LIABILITIES OF HYPOTHETICAL TAXPAYERS, 1994 [62]

Income	Income Tax liability	FICA tax liability	Total tax liability	Overall average taxrate [a] (percent)	Overall marginal taxrate [b] (percent)
Joint filer — 3 exemptions: [c]					
$ 10,000	-$2,038	$1,530	-$508	-4.7	14.2
$ 30,000	2,445	4,590	7,035	21.8	28.1
$ 50,000 [d]	4,898	7,650	12,548	23.3	40.2
$100,000 [e]	15,402	10,042	25,444	24.2	30.5
Head of household — 2 personal exemptions: [f]					
$ 10,000	-2,038	1,530	-508	-4.7	14.2
$ 30,000	2,865	4,590	7,455	23.1	28.1
$ 50,000 [g]	5,863	7,650	13,513	25.1	40.2
$100,000 [h]	$17,063	10,042	27,105	25.8	33.4
Elderly couple filing joint return:					
$10,000 [i]	0	0	0	0.0	0.0 [j]
$30,000 [k]	788	0	788	2.6	15.0 [l]
$50,000 [m]	4,688	1,530	6,218	12.2	40.0

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62 Table 3 assumptions and explanations:

(a) The average tax rate is total tax liability divided by income plus the employer share of FICA. Unless otherwise noted, all calculations assume the taxpayer takes the standard deduction rather than itemized deductions.

(b) The marginal rate computations also count the employer share of FICA tax as income to the employee (for both payroll and income tax purposes).

(c) Assumes one child, one earner, and all income is wage income.

(d) Assumes taxpayer claims itemized deductions of $10,000.

(e) Assumes taxpayer claims itemized deductions of $20,000.

(f) Assumes one child, one earner, and all income is wage income.

(g) Assumes taxpayer claims itemized deductions of $10,000.

(h) Assumes taxpayer claims itemized deductions of $20,000.

(i) All income is Social Security.

(j) If the marginal dollar of income is assumed to consist of wage income, the marginal tax rate would be 14.2%. This represents the FICA tax liability on this income.

(k) $12,000 is Social Security, $12,000 is a taxable pension and $6,000 is taxable interest.

(l) If the marginal dollar of income is assumed to consist of wage income, the marginal tax rate would be 28.1%, representing both the income tax liability and the FICA tax liability on this income.

(m) Same as above plus additional $10,000 of taxable interest and $10,000 of wages.

TABLE 3. EXAMPLES OF FEDERAL INCOME AND PAYROLL TAX LIABILITIES OF HYPOTHETICAL TAXPAYERS, 1994 (cont'd)[62]

Income	Income Tax liability	FICA tax liability	Total tax liability	Overall average taxrate (percent)	Overall marginal taxrate (percent)
Elderly single filer:					
$10,000 [n]	0	0	0	0.0	0.0 [o]
$30,000 [p]	2,389	0	2,839	8.0	22.5 [q]
$50,000 [r]	8,712	3,060	11,772	22.8	40.2

Source: GREEN BOOK: *supra* note 12, at 720.

[62] Table 3 assumptions and explanations (cont'd):

(n) $7,500 is Social Security, $2,500 is taxable pension.

(o) If the marginal dollar of income is assumed to consist of wage income, the marginal tax rate would be 14.2%. This represents the FICA tax liability on this income.

(p) $7,500 is Social Security, $7,500 is taxable pension, $15,000 is taxable interest.

(q) If the marginal dollar of income is assumed to consist of wage income, the marginal tax rate would be 35.1%, representing both the income tax liability (22.5% marginal rate reflects the inclusion of 50 cents of Social Security benefits as taxable for each additional dollar of AGI) and the FICA tax liability on this income.

(r) Same as above plus $20,000 of wages.

TABLE 4. DISTRIBUTION OF EARNERS BY INCOME AND MARGINAL TAX RATES ON WAGES,[63] 1995

[In thousands of earners, tax rates in percent]

	Income in thousands of 1995 dollars									
Marginal tax rate	<10	10-20	20-30	30-40	40-50	50-75	75-100	100-200	200+	All incomes
All earners ages 21-64 without Social Security benefits										
Mean marginal tax rate	5.6	24.4	26.6	25.8	25.1	30.6	34.4	34.9	43.3	25.6
Mean marginal income tax rate	-2.0	16.8	19.0	18.1	17.5	23.4	28.0	30.2	39.9	18.3
Mean marginal Social Security tax rate	7.6	7.6	7.6	7.6	7.6	7.3	6.3	4.8	3.4	7.3
Single earners										
Mean marginal tax rate	7.8	24.5	25.1	31.5	34.1	34.2	32.8	34.9	41.1	22.5
Mean marginal income tax rate	0.1	16.9	17.5	23.8	26.5	28.0	30.3	32.8	39.6	15.1
Mean marginal Social Security tax rate	7.6	7.6	7.6	7.6	7.6	6.2	2.5	2.1	1.4	7.5
Married earners										
Mean marginal tax rate	-5.2	24.1	28.3	22.8	22.8	30.2	34.4	34.9	43.5	27.5
Mean marginal income tax rate	-12.9	16.5	20.6	15.2	15.1	22.8	27.9	30.0	39.9	20.3
Mean marginal Social Security tax rate	7.6	7.6	7.6	7.6	7.6	7.4	6.5	4.9	3.6	7.2
Earners with children										
Mean marginal tax rate	-16.8	28.1	32.2	22.8	22.9	28.5	34.2	34.7	43.7	25.1
Mean marginal income tax rate	-24.4	20.4	24.5	15.1	15.3	21.1	27.9	30.0	40.2	17.9
Mean marginal Social Security tax rate	7.6	7.6	7.6	7.6	7.6	7.3	6.2	4.7	3.4	7.2

Source: GREEN BOOK, *supra* note 12, at 725–28

63 Marginal tax rates are the combined tax rates on an additional dollar of earnings of the federal individual income tax and the employee share of the Social Security payroll tax.

3. *Additional Comments About the Impact of Excise Taxes on Low-Income Individuals*

Although this Article does not give detailed consideration to the impact of current federal excise taxes on low-income individuals, a few comments are pertinent before moving on. First, it should be noted that most excise taxes are regressive.[64] That is, like sales taxes, the burden of most excise taxes falls disproportionately on low-income individuals. For example, high- and low-income individuals are likely to use about the same amount of gasoline in their cars and so pay about the same amount of gasoline excise taxes. As a result, low-income individuals will spend a greater percentage of their incomes on gasoline than high-income individuals. Moreover, increases in excise taxes (like the recent 4.3 cent per gallon increase in the gasoline excise tax) will tend to have a disproportionate impact on low-income individuals.[65]

Second, as with Social Security taxes, the refundable earned income credit can offset excise taxes paid by low-income individuals. Indeed, one of the reasons that the Omnibus Budget Reconciliation Act of 1993 raised the earned income credit and extended it to many childless workers was that Congress wanted to offset the regressive impact of the concomitant increase in the gasoline excise tax.[66]

B. *Returns, Paperwork, and Refunds*

Even though relatively few low-income individuals have net federal tax liabilities, most must file income tax returns to recover their over-withheld taxes and refundable earned income credits. This Subpart discusses the impact of the return-filing process on low-income taxpayers and on the IRS. All in all,

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[64] On the other hand, an excise tax on luxury goods or expensive cars would tend to be progressive.

[65] *See generally* STAFF OF THE JOINT COMM. ON TAXATION, 103D CONG., 1ST SESS., METHODOLOGY AND ISSUES IN MEASURING CHANGES IN THE DISTRIBUTION OF TAX BURDENS 60, 66 (1993).

The Omnibus Budget Reconciliation Act of 1993 raised the gasoline excise tax by 4.3 cents per gallon, starting on October 1, 1993. The Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, § 13,241, 107 Stat. 312, 510–14 (1993). This provision costs the average driver about $35 per year, and it is expected to raise roughly $24 billion over five years. OFFICE OF MANAGEMENT AND BUDGET, 103D CONG., 1st. SESS., MID-SESSION REVIEW OF THE 1994 BUDGET 6 (Comm. Print 1993) *microformed on* Sup. Docs. No. Y 1.1/7:103–133 (U.S. Gov't Printing Office).

[66] George K. Yin et al., *Improving the Delivery of Benefits to the Working Poor: Proposals to Reform the Earned Income Credit Program*, 11 AM. J. TAX POL'Y 225, 233 n.18 (1994).

this Subpart shows that filing returns is burdensome and expensive for low-income taxpayers and for the IRS.

1. *Overview of the Returns Filed by Low-Income Individuals*

Table 5 shows the number of individual income tax returns filed by individuals with varying amounts of adjusted gross income for the tax year 1993.[67] At the outset, Table 5 shows that almost 25% of the 114.6 million individual income tax returns filed in 1993 showed no income tax liability. That's roughly 28 million returns, and most of those were filed by low-income individuals. For example, of the almost 6 million returns filed by taxpayers with adjusted gross income between $7,000 and $9,000, almost 43% had no income tax liability—some 2.5 million returns.

Table 6 provides more detailed individual income data for tax year 1993 for all individual income tax returns and for most low-income taxpayers.[68] Table 6 shows that a remarkable 45 million taxpayers with adjusted gross incomes of less than $15,000 filed income tax returns in 1993. Of these, only about 24 million actually owed any income tax, and the average tax owed by these 24 million was just $570.[69] Moreover, almost 10 million of these taxpayers received earned income credit refunds in excess of their preliminary individual income tax liabilities.

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[67] *Selected IRS Data*, *supra* note 21, at 197–98.

[68] *Id.* at 142.

[69] $13,849,786,000 total tax liability divided by 24,285,400 returns equals $570.29 per taxable return.

TABLE 5. NUMBER OF INDIVIDUAL RETURNS, INCOME, TAX AND AVERAGE TAX BY SIZE OF ADJUSTED GROSS INCOME, TAX YEAR 1993

			Returns showing total income tax	
Size of adjusted gross income	Number of returns	Percentage of returns showing no total income tax	Average tax (whole dollars)	Tax as% of AGI
Total	114,601,819	24.6	5,817	14.1
No adjusted gross income	920,431	99.5	13,561	-
$1 under $1,000	2,630,024	81.0	39	4.6
$1,000 under $3,000	6,472,017	76.6	75	4.0
$3,000 under $5,000	5,748,112	73.9	151	3.7
$5,000 under $7,000	5,825,575	64.0	213	3.4
$7,000 under $9,000	5,963,864	42.8	333	4.2
$9,000 under $11,000	5,701,001	44.9	589	5.9
$11,000 under $13,000	5,496,355	37.3	755	6.3
$13,000 under $15,000	5,210,087	33.1	927	6.6
$15,000 under $17,000	4,859,885	32.0	1,148	7.2
$17,000 under $19,000	4,306,292	21.0	1,293	7.2
$19,000 under $22,000	6,252,720	7.4	1,543	7.5
$22,000 under $25,000	5,426,552	2.0	1,950	8.3
$25,000 under $30,000	7,783,772	1.6	2,422	8.9
$30,000 under $40,000	12,358,342	0.6	3,521	10.1
$40,000 under $50,000	9,072,138	0.4	4,813	10.8
$50,000 under $75,000	12,248,446	0.3	7,454	12.3
$75,000 under $100,000	4,224,878	0.1	12,812	15.0
$100,000 under $200,000	3,107,998	0.1	24,257	18.5
$200,000 under $500,000	786,038	0.1	74,223	25.6
$500,000 under $1,000,000	140,803	0.1	201,499	30.1
$1,000,000 or more	66,485	0.1	801,583	31.2

Source: *Selected IRS Data, supra* note 21, at 170.

TABLE 6. INDIVIDUAL INCOME AND TAX DATA BY ADJUSTED GROSS INCOME, INCOME TAX YEAR 1993

Item	All returns	Under $15,000	$15,000 under $30,000
Number of returns	115,060,797	44,527,163	28,659,814
Number with paid preparer's signature	57,070,701	19,415,624	13,908,058
Number of exemptions	253,489,483	19,415,624	13,908,058
Adjusted gross income (less deficit)	3,720,610,776	261,339,962	622,373,528
Salaries and wages:			
Number of returns	97,606,968	34,713,542	24,696,469
Amount	2,880,337,902	245,154,068	496,844,426
Interest Income:			
Number of returns	65,431,116	16,823,648	14,790,591
Amount	133,052,198	22,822,663	22,477,475
Dividends:			
Number of returns	24,819,456	5,277,264	4,567,327
Amount	81,239,203	7,821,074	9,542,157
Net capital gain (less loss):			
Number of returns	14,275,285	2,732,193	2,522,208
Amount	140,894,028	8,015,369	5,233,561
Taxable pensions and annuities:			
Number of returns	17,339,457	5,060,442	4,909,660
Amount	192,215,255	28,589,605	50,468,102
Unemployment compensation:			
Number of returns	9,613,641	3,250,925	2,885,762
Amount	28,367,400	8,647,876	9,009,486
Number of sole proprietorship returns	15,841,373	4,707,329	3,437,041
Number of farm returns (Schedule F)	1,927,995	583,686	478,712
Total itemized deductions:			
Number of returns	33,482,180	2,144,349	5,078,148
Amount	514,508,086	33,167,452	52,889,092
Medical and dental expense:			
Number of returns	5,859,168	1,270,742	1,898,002
Amount	38,184,323	14,416,794	10,799,204

TABLE 6. INDIVIDUAL INCOME AND TAX DATA BY ADJUSTED GROSS INCOME, INCOME TAX YEAR 1993 (cont'd)

Item	All returns	Under $15,000	$15,000 under $30,000
Taxes paid deductions:			
Number of returns	32,896,322	1,910,783	4,920,454
Amount	175,377,096	5,848,638	11,516,913
Interest paid deductions:			
Number of returns	27,831,752	1,266,649	3,759,217
Amount	203,920,162	9,246,603	19,452,328
Contributions:			
Number of returns	29,972,765	1,337,713	4,229,949
Amount	68,304,562	1,427,679	5,591,418
Taxable income:			
Number of returns	91,337,398	21,968,683	27,619,855
Amount	2,455,262,093	68,648,476	321,871,153
Total tax liability:			
Number of returns	93,736,009	24,285,400	27,686,925
Amount	532,213,236	13,849,786	51,982,016
Earned income credit:			
Number of returns	15,300,754	10,172,551	5,128,203
Amount	15,675,410	12,398,698	3,276,712
Excess earned income credit:			
Number of returns	12,225,248	9,887,500	2,337,748
Amount	12,036,900	10,757,202	1,279,698
Overpayment			
Number of returns	79,308,075	33,288,000	20,992,456
Amount	85,533,297	23,631,606	18,420,372
Tax due at time of filing			
Number of returns	28,335,385	6,911,585	6,641,963
Amount	50,568,936	2,789,145	5,383,214

Source: *Selected IRS Data*, *supra* note 21, at 144.

In that regard, it is worth noting that most individual income taxpayers receive refunds when they file their tax returns. For example, of the 113.6 million income tax returns filed for 1992, 68% got refunds (77.8 million taxpayers).[70] Among taxpayers with adjusted gross incomes under $20,000 in 1992, more than 76% got refunds, and the average refund was almost $700.[71]

[70] INTERNAL REVENUE SERVICE, STATISTICS OF INCOME—1992 INDIVIDUAL INCOME TAX RETURNS 89-94 (1995). Similarly, in 1993, more than 79 million taxpayers were

Table 6 also provides some information about the complexity of returns filed by low-income individuals. For example, Table 6 shows that virtually all low-income individuals claimed the standard deduction on their income tax returns: less than 5% of taxpayers with adjusted gross income of $15,000 or less itemized their deductions, and less than 20% of those with adjusted gross incomes of $15,000 to $30,000 itemized. Also, Table 6 shows that earned income (salaries and wages) constitutes the lion's share of income earned by low-income individuals. Indeed, relatively few low-income individuals report any interest, dividends, or capital gains on their returns.[72]

2. *The Burdens Associated with the Income Tax Returns Filed by Low-Income Individuals*

The current individual income tax system imposes heavy costs and burdens on both the low-income individuals and the IRS. Table 7 shows the General Accounting Office's estimates of the cost to file and process individual income tax returns for tax year 1991.[73] As can be seen from that table, it is time-consuming and expensive for individuals to file returns and for the IRS to process them.

Moreover, in a typical year, millions of individuals need help preparing their income tax returns. Table 8 shows the various types of taxpayer assistance that individuals received in 1993.[74] All in all, the General Accounting Office has estimated that Americans may spend as much as $30 billion a year to prepare their individual income tax returns.[75] The Tax Foundation has estimated that the cost of complying with federal taxes for individuals may be as high as $65 billion a year.[76]

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entitled to refunds totalling almost $85 billion, while roughly 29 million taxpayers owed about $50 billion at the time of filing. *Selected IRS Data*, *supra* note 21, at 143.

71 Author's computations from INTERNAL REVENUE SERVICE, STATISTICS OF INCOME—1992 INDIVIDUAL INCOME TAX RETURNS 94 (1995).

72 *Cf.* Subsection IV.B.2.c., *infra.*

73 GENERAL ACCOUNTING OFFICE, INTERNAL REVENUE SERVICE, OPPORTUNITIES TO REDUCE TAXPAYER BURDENS THROUGH RETURN-FREE FILING 37 (1992) *microformed on* GAO/GGD-92-88BR [hereinafter OPPORTUNITIES TO REDUCE TAXPAYER BURDENS].

74 *Selected IRS Data*, *supra* note 21 at 217.

75 OPPORTUNITIES TO REDUCE TAXPAYER BURDENS, *supra* note 73, at 1.

76 Arthur P. Hall, *The Cost of Unstable Tax Laws*, 65 TAX NOTES 759 (1994); Arthur P. Hall, *Growth of Federal Government Tax 'Industry' Parallels Growth of Tax Code*, 65 TAX NOTES 1133, 1135 (1994).

C. *Recent Simplification Efforts by the IRS*

1. *Alternative Filing Methods Generally*

Recently, the IRS has implemented a variety of alternative tax methods that have helped reduce burdens on many low-income individuals. Forms 1040A and 1040EZ were themselves efforts to reduce the burden on individual taxpayers. Newer alternatives include electronic filing, 1040 PC, Telefile, and 1040EZ-1.

TABLE 7. COST TO FILE AND PROCESS U.S. TAX FORMS

Tax Form	Total number filed for tax year 1991	Total hours spent by taxpayers to file forms	Total cost to IRS to process forms
1040EZ	17,358,394	35,006,673	$47,214,832
1040A	22,439,861	149,599,821	68,441,576
1040	74,685,853	725,700,028	256,919,334

Source: OPPORTUNITIES TO REDUCE TAXPAYER BURDENS, *supra* note 73, at 37.

Electronic filing allows IRS-approved tax preparers to send tax returns over telephone lines directly to the IRS service center computers. Telefile allows taxpayers to file 1040EZ returns using touch-tone phones. The 1040PC program allows taxpayers to prepare tax returns on their own personal computers. Finally, Form 1040EZ-1 is a simplified form of the 1040EZ. A taxpayer answers a few questions, attaches any W-2s, and signs the form. The IRS then figures the tax liability and sends the taxpayer a refund or a notice of any tax due, together with an explanation of how the tax was figured. Table 9 shows the recent utilization of these newer alternative filing methods.[77]

2. *Electronic Filing*

So far, the most important of these alternatives is electronic filing. Under this program, IRS-approved tax preparers and transmitters send tax returns directly to the IRS service center's computer system. There, the information is automatically edited, processed, and stored. The refund can even be electronically deposited in the individual's account at a bank or other financial institution. Moreover, through so-called refund anticipation loans, taxpayers

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[77] OPPORTUNITIES TO REDUCE TAXPAYER BURDENS, *supra* note 73, at 34.

can usually get spending money even earlier than they could receive their refunds.

TABLE 8. TAXPAYERS RECEIVING ASSISTANCE, PAID AND UNPAID, TAX YEAR 1993 [in thousands]

Type of assistance	Number of Taxpayers
Returns with paid preparer signature:	
All returns	56,588
1040EZ	1,527
1040A	5,823
1040, total	49,239
1040 Business, total	12,834
Nonfarm	10,894
Farm	1,459
1040 Nonbusiness, total	36,405
With itemized deductions	14,793
Without itemized deductions	21,612
Electronically filed	9,477
Assistance provided by IRS:	
Telephone inquiries (including recorded telephone information)	66,253
Office walk-ins, information	7,149
Written inquiries	270
Special programs:	
Community classes and seminars (taxpayers assisted)	751
Volunteer Income Tax Assistance (VITA) and Tax Counseling	
for the Elderly (taxpayers assisted)	3,170

Source: *Selected IRS Data*, *supra* note 21, at 217.

TABLE 9. ALTERNATIVE FILING METHODS

Alternative	Availability during 1991	Type of filer	Anticipated returns for 1992	Returns received as of 4/10/92
Electronic filing	Nationwide	1040/A/EZ	11,000,000	10,380,000
1040PC	Nationwide	1040/A/EZ	2,000,000	983,000
Telefile	Ohio	1040EZ	150,000	121,000
1040EZ-1	Rhode Island, Texas, Washington	1040EZ	17,000	5,000

Source: OPPORTUNITIES TO REDUCE TAXPAYER BURDENS, *supra* note 73, at 34.

The IRS started accepting electronically-filed income tax returns in 1986, and, as shown in Table 10, the number of electronic filing participants and the number of returns being submitted electronically have increased considerably.[78] By the year 2001, the Internal Revenue Service hopes to convert some 80% of all taxpayers to electronic filing.[79]

The principal advantages of electronic filing are that taxpayers can get their refunds faster, returns are more accurate, and electronic returns cost less for

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[78] INTERNAL REVENUE SERVICE, HANDBOOK FOR ELECTRONIC FILERS OF INDIVIDUAL INCOME TAX RETURNS (Tax Year 1993), PUB. NO. 1345, 12 (revised Dec. 1993) [hereinafter HANDBOOK FOR ELECTRONIC FILERS]. *But see* Ryan J. Donmoyer, *Electronic Filing Down 19 Percent Through Mid-March, IRS Reports*, 66 TAX NOTES 1905 (1995).

According to a recent IRS study:

> In 1991, nearly seven percent of Americans who filed an individual income tax return did so electronically. Electronic filers typically file Form 1040A, are less than 45 years old, have a household income of less than $30,000, and/or live in the South. The motivating factor for electronic filers is getting a quick refund. Those most unlikely to be electronic filers are over the age of 60, living in the West, and filing Form 1040. They are not electronically filing their tax returns primarily because they are not aware of the option or the cost is too high. Survey results suggest that if the IRS can get refunds issued in five business days, and if transmitters reduce the cost to less than $20, millions of additional taxpayers would be enticed to file electronically.

Bryan L. Musselman, *Electronic Filing—Who's Participating and Who Isn't*, 1991 INTERNAL REVENUE SERVICE RES. BULL. 27 (1991).

[79] Rita L. Zeidner, *TSM: How the Service Plans to Move into the 21st Century*, 63 TAX NOTES 1239, 1241 (1994).

the IRS to store.[80] Because electronically-filed returns bypass the mail and the service center's manual process for handling paper returns, taxpayers can usually receive their refund checks in a few weeks.

On the other hand, electronic filing has a number of disadvantages.[81] It is neither return-free nor paperless: returns must still be prepared, and the taxpayer must still submit a signature document and copies of the relevant W-2s. Also, taxpayers generally will have to pay to have returns prepared and electronically transmitted to the IRS, and taxpayers will have to pay even more if they want refund anticipation loans.[82] Thus, while electronic filing may be less expensive for the IRS, it can be more expensive for taxpayers, and especially for low-income taxpayers.[83]

TABLE 10. SUCCESS OF ELECTRONIC FILING AT A GLANCE

Processing Year	Participants	Electronic Returns
1986	5	25,000
1987	66	78,000
1988	2,407	583,462
1989	9,429	1,200,000
1990	21,539	4,191,304
1991	34,859	7,522,708
1992	55,511	10,923,911
1993	65,217	12,343,000

Source: HANDBOOK FOR ELECTRONIC FILERS, *supra* note 78, at 12.

Finally, bypassing the slower paper processing of returns has increased the potential for tax refund fraud. In that regard, both Congress and Treasury have expressed concern about fraudulent electronic returns.[84] In response, the IRS recently toughened procedures for IRS-approved tax preparers and transmitters.[85]

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80 OPPORTUNITIES TO REDUCE TAXPAYER BURDENS, *supra* note 73, at 14–15.

81 *Id.* at 14–17.

82 For example, H & R Block charges $35 just for the electronic transmission. Also, according to the Electronic Filing Coalition of America, the service charge for a refund anticipation loan in 1994 was typically between $29 and $34. George Guttman, *News Analysis: Electronic Filing: Who Pays, Who Benefits*, 66 TAX NOTES 1750, 1754–55 (1995).

83 *See* George Guttman, *Improper Refunds Sapping Billions; IRS, Treasury, Hill Seek Answers*, 65 TAX NOTES 19, 20 (1994); William J. Turnier, *Electronic Filing: A Very Dubious Success*, 59 TAX NOTES 569 (1993).

84 *See, e.g.*, Guttman, *supra* note 83.

85 Rev. Proc. 94-63, 1994-2 C.B. 785.

IV. OPTIONS FOR SIMPLIFICATION

This Part discusses various approaches to simplifying the tax system for low-income individuals. The idea here is to consider changes that would: (1) simplify the return-filing process for those low-income taxpayers who must file returns; and (2) reduce the number of low-income taxpayers required to file tax returns.[86]

Subpart A focuses on the need for simplification and reconsiders the income and Social Security taxes in historical perspective. Subpart B first considers some statutory and regulatory changes that would simplify current income tax returns and the current return-filing process. Finally, Subpart C considers the potential impact of three more fundamental changes to the current federal tax system: (1) integrating the income and Social Security taxes; (2) shifting to a flat tax, perhaps with consumption replacing income as the tax base; and (3) moving to a return-free system.

A. *The Need For Simplification*

1. *The Problem of Complexity*

Complexity is a major problem for the federal tax system. Complexity erodes voluntary compliance with the tax laws, creates a perception of unfairness for the system, impedes the effective administration of the tax laws, results in high compliance costs, and interferes with economic transactions.[87]

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[86] While most everyone agrees that the filing process needs to be simplified, not everyone agrees that reducing the number of taxpayers who have to file returns is an important goal. Some believe that every citizen with income should have to file a return. Also, some believe that filing a tax return is a way of reaffirming "the social contract." Moreover, having citizens file returns when they have low-incomes may promote greater compliance if they later have higher incomes. Finally, eliminating the federal filing requirement would do little to ease the burden of filing state income tax returns. In that regard, state income tax returns often use federal adjusted gross income as a starting point, and state income tax systems often have much lower tax thresholds than the federal income tax.

[87] *See generally* AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, BLUEPRINT FOR TAX SIMPLIFICATION (1992); FEDERAL INCOME TAX SIMPLIFICATION (Charles H. Gustafson ed. 1979) (reporting on the 1978 Conference on Federal Income Tax Simplification cosponsored by the American Bar Association and the American Law Institute); Invitational Conference on Reduction of Income Tax Complexity, January 11–12, 1990: A Joint Conference of the American Institute of Certified Public Accountants Tax Division and the American Bar Association Section of Taxation (looseleaf materials

Consequently, simplification of the tax system holds the promise for significant economic and equitable gains. It may not be possible to simplify the federal tax system for all taxpayers, or even just for all individual taxpayers. But it should be possible to simplify the federal tax system for low-income individuals.

At the outset, however, it must be noted that many of the simplification proposals discussed in this Part would affect the revenue and equity of the federal tax system. These impacts, of course, must be weighed against the benefits of simplification. Nevertheless, the author of this Article believes that significant simplification could be achieved while maintaining both revenue-neutrality and distributional equity.

2. *Federal Taxes in Historical Perspective*

Before progressing to consideration of how to simplify the tax system for low-income individuals, it is worth acknowledging that the federal tax system has not always been so complicated for low-income taxpayers. After all, the individual income tax was only enacted in 1913, and the first Social Security tax was enacted in 1935. Thus, direct taxation of the masses is a relatively recent phenomenon.

As originally enacted in 1913, the individual income tax was designed to affect only a small number of households. For example, for married couples, the tax did not apply to couples whose income was less than $3,000 (quite a sum for that time).[88] The federal income tax was expanded along with the increased federal expenditures necessitated by World War I, the Depression, and World War II. By 1948, the exemption was just $600 for single taxpayers

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available from the American Bar Association Section of Taxation, 1990); GENERAL ACCOUNTING OFFICE, TAX GAP: MANY ACTIONS TAKEN, BUT A COHESIVE STRATEGY NEEDED (1994) *microformed on* GAO/GGD-94-123 [hereinafter TAX GAP]; Michael C. Durst, *Report of the Second Invitational Conference on Income Tax Compliance*, 42 TAX LAWYER 705 (1989) (reporting on a 1988 conference cosponsored by the Section of Taxation and the American Bar Foundation); Martin J. McMahon, Jr., *Individual Tax Reform for Fairness and Simplicity: Let Economic Growth Fend for Itself*, 50 WASH. & LEE L. REV. 459 (1993); Deborah H. Schenk, *Simplification for Individual Taxpayers: Problems and Proposals*, 45 TAX L. REV. 121 (1989); Karla W. Simon, *Tax Simplification and Justice*, 36 TAX NOTES 93 (1987).

[88] STAFF OF THE HOUSE COMM. ON WAYS AND MEANS, 103D CONG., 1ST SESS., OVERVIEW OF THE FEDERAL TAX SYSTEM 49 (1993); *see also* J. MARTIN BURKE & MICHAEL K. FRIEL, TAXATION OF INDIVIDUAL INCOME 4 (3d ed. 1994) (indicating that in 1920, only about five and one-half million taxable individual income tax returns were filed, even though more than 62 million Americans were over age 19). Similarly, see J. Clifton Fleming, Jr., *Scoping Out the Uncertain Simplification (Complication?) Effects of VATs, BATs and Consumed Income Taxes*, 2 FLA. TAX REV. 390, 442–43 (1995).

and dependents and $1,200 for couples and heads of household. Today's personal exemption would have to exceed $9,000 to be equivalent in value to the $600 personal exemption of 1948,[89] yet the personal exemption is just $2,550 in 1996.

Similarly, as originally enacted in 1935, the Social Security Act provided for extremely low tax rates on a relatively low wage base. As Table 11 shows, until 1950, employees and employers each paid Social Security taxes of just 1% of the first $3,000 of wages.[90] Even in 1960, employees and employers each paid Social Security taxes of just 3% of the first $4,800 of wages. These figures present a stark contrast to the situation in 1996 when employees and employers each must pay Social Security taxes of 7.65% of the first $62,700 of wages and 1.45% of wages over $62,700.

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[89] *Cf.*, *Reclaiming the Tax Code for American Families: Hearing Before the House Select Committee on Children, Youth and Families*, 102d Cong., 1st Sess. 3 (1991) (statement of Rep. Patricia Schroeder) (stating today's personal exemption would have to be around $7000 to be equivalent in value to the $600 personal exemption of 1948); *see also* Charles O. Galvin, *Tax Policy—Past, Present, and Future*, 49 SMU L. REV. 83 (1995).

[90] GREEN BOOK, *supra* note 12, at 76.

TABLE 11. PAYROLL TAX RATES FOR EMPLOYEES AND EMPLOYERS AND WAGE BASE LEVELS [91]

Calendar years	Social Security wage base [a]	Tax rates (percent) for employer and employee Total
1937-49	$3,000	1.000
1950	3,000	1.500
1951-53	3,600	1.500
1954	3,600	2.000
1955-56	4,200	2.000
1957-58	4,200	2.250
1959	4,800	2.500
1960-61	4,800	3.000
1962	4,800	3.125
1963-65	4,800	3.625
1966	6,600	4.200
1967	6,600	4.400
1968	7,800	4.400
1969	7,800	4.800
1970	7,800	4.800
1971	7,800	5.200
1972	9,000	5.200
1973	10,800	5.850
1974	13,200	5.850
1975	14,100	5.850
1976	15,300	5.850
1977	16,500	5.850
1978	17,700	6.050
1979	22,900	6.130
1980	25,900	6.130
1981	29,700	6.650
1982	32,400	6.700

91 Table 11 explanations:

(a) The maximum amount of taxable earnings for the Hospital Insurance (HI) program is the same as that for the Old Age Survivors and Disability Insurance (OASDI) program for 1966–90. Separate HI taxable maximums of $125,000, $130,200, and $135,000 were applicable to the years 1991–93, respectively. After 1993, the limitation on taxable earnings for the HI program does not apply.

(b) Increases automatically with increases in the average wage index.

(c) Increases automatically with increases in the average wage index.

TABLE 11. PAYROLL TAX RATES FOR EMPLOYEES AND EMPLOYERS AND WAGE BASE LEVELS (cont'd)

1983	35,700	6.700
1984	37,800	7.000
1985	39,600	7.050
1986	42,000	7.150
1987	43,800	7.150
1988	45,000	7.510
1989	48,000	7.510
1990	51,300	7.650
1991	53,400	7.650
1992	55,500	7.650
1993	57,600	7.650
1994	60,600	7.650
1995	61,200	7.650
1996	62,700	7.650
1997-99	([b])	7.650
2000+	([c])	7.650

Sources: GREEN BOOK: *supra* note 12, at 76. Social Security COLA, *supra* note 29, at 54,753 (1995).

With the repeated expansion of the earned income credit and the development of electronic filing, the federal tax system may have started to reverse its course. Perhaps these developments reflect a Congressional desire to reduce the tax burdens on low-income individuals. If so, then the options considered in the following Subparts should be especially relevant to Congressional policymakers.

B. *Simplify Current Returns and the Return-Filing Process*

1. *Simplify the Current Return-Filing Process*

This Section identifies a number of options for simplifying the return-filing process for low-income individuals.

a. *The IRS Should Continue Its Efforts to Simplify the Tax System for Low-Income Taxpayers*

To date, low-income taxpayers have especially benefited from the IRS's efforts to simplify the individual income tax system, and the IRS should continue with those efforts. In general, the IRS should continue: (1) working to simplify its forms and publications; (2) developing and expanding its taxpayer assistance programs; and (3) exploring and expanding alternative filing methods. In particular, measured expansion of the electronic filing and Telefile programs should result in significant simplification for both low-income taxpayers and for the IRS.

b. *Let the IRS Help Taxpayers Prepare Returns*

The IRS believes that it is barred from preparing income tax returns for individuals by Office of Management and Budget Circular A-76.[92] Promulgated by the Reagan Administration, that circular was designed to prevent government agencies from "competing" with private-sector businesses. The IRS believes that Circular A-76 prevents it from preparing income tax returns, setting up its own electronic filing network, or designing and distributing computer software that would allow individuals to prepare their returns on their own computers. Modifying that Circular, or at least the IRS's interpretation of it, would enable the IRS to help taxpayers prepare their income tax returns.

Table 8 shows that more than 56 million taxpayers used paid preparers for their 1993 tax returns. That is about half of all individual taxpayers. Even more astonishing, 1.5 million taxpayers paid private preparers to help them fill out 1040EZ forms, and more than 5.8 million taxpayers paid preparers to help them fill out 1040A forms. Furthermore, half of earned income credit recipients use paid preparers.[93]

At $20 or more per return for preparation and additional fees for electronic filing and refund anticipation loans, that amounts to millions of dollars going to private preparers. If the government is truly interested in helping individual income taxpayers and in simplifying the tax system, then the IRS should be allowed to directly assist taxpayers in the preparation of their returns. In particular, it would make sense to let the IRS prepare returns for those low-income taxpayers who claim the earned income credit. Virtually all welfare programs help individuals apply for benefits,[94] and the earned income credit

[92] Office of Management and Budget Circular No. A-76, *Performance of Commercial Activities*, 48 Fed. Reg. 37,110 (1983).

[93] GENERAL ACCOUNTING OFFICE, EARNED INCOME CREDIT: TARGETING THE WORKING POOR 31 (GAO/GGD-95-122BR) (1995).

[94] For example, local welfare agencies help low-income individuals claim their Aid to Families with Dependent Children, food stamp, and Medicaid benefits. Similarly, the Social Security Administration has local offices all around the country that give potential beneficiaries any help they need in completing the application process, including notary services, free of charge. Moreover, Social Security Administration personnel routinely visit additional locations, and even make home visits to potential beneficiaries who because of

clearly provides a welfare-like benefit.[95] Why not let the IRS prepare returns so that eligible low-income individuals can claim their earned income credit refunds?

c. *Expand Withholding*

Withholding works. Withholding helps the IRS collect the right amount of tax and it helps individuals comply with the tax laws. Consequently, expanding withholding to more types of income could reduce the individual income tax gap ($94 billion in 1992)[96] and could simplify the income tax system for many individuals.

So far, Congress has balked at the idea of across-the-board mandatory withholding on payments to independent contractors, interest, dividends, state tax refunds, and many other forms of miscellaneous income.[97] Where withholding is applicable, however, individuals have a tremendous incentive to report the underlying income, and properly reporting the income helps both the IRS and the taxpayer. In particular, wage withholding is the very "cornerstone of our tax compliance system for employees," and it has resulted in 99% of wages being voluntarily reported on income tax returns.[98]

In the absence of withholding, however, taxpayers often have little incentive to report the underlying income and pay the taxes due thereon. For example, independent contractors report just 97% of the income that appears on information returns and just 83% of other self-employment earnings.[99] Indeed, many independent contractors do not even file returns.

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illness or injury cannot make an office visit. *See, e.g.*, CCH, 1994 SOCIAL SECURITY EXPLAINED 298 (1994).

[95] *See, e.g.*, Anne L. Alstott, *The Earned Income Tax Credit and the Limitations of Tax-Based Welfare Reform*, 108 HARV. L. REV. 533 (1995).

[96] TAX GAP, *supra* note 87, at 57.

[97] Most notably, Congress passed, then repealed, withholding on interest and dividends back in the early 1980's. *See, e.g.*, Interest and Dividend Compliance Act of 1983, Pub. L. No. 98-67, § 102, 97 Stat. 369 (1983). Today, the hot withholding issue involves the classification of workers as employees or independent contractors. *See, e.g.*, GENERAL ACCOUNTING OFFICE, TAX ADMINISTRATION: APPROACHES FOR IMPROVING INDEPENDENT CONTRACTOR COMPLIANCE (1992), *microformed on* GAO/GGD-92-108 [hereinafter APPROACHES FOR IMPROVING INDEPENDENT CONTRACTOR COMPLIANCE].

[98] GENERAL ACCOUNTING OFFICE, TAX ADMINISTRATION: IMPROVING INDEPENDENT CONTRACTOR COMPLIANCE 5 (1992), *microformed on* GAO/T-GGD-92-63 (testimony of Natwar M. Gandhi before the Subcommittee on Select Revenue Measures of the House Committee on Ways and Means).

[99] *Id.* at 7. In general, a business is required to withhold income and Social Security taxes from any worker who is classified as an employee. On the other hand, if a business

Moreover, the absence of withholding can cause financial hardships for low-income workers who are classified as independent contractors (e.g., taxi drivers and hair stylists). Such low-income "independent contractors" can often find it difficult to save enough money during the year to meet their income and Social Security taxes the following April 15. No doubt, many of them end up as nonfilers or collection problems.

Similarly, consider a hypothetical low-income individual who works part of the year, receives unemployment benefits part of the year, and ends the year homeless.[100] Although unemployment benefits are taxable, states are not required to withhold taxes on unemployment benefits.[101] Consequently, rather then getting a refund, our hypothetical homeless individual may find she actually owes income tax for the prior year.[102] That leaves her with little incentive to file a proper income tax return. One solution would be to require that taxes be withheld from unemployment benefits.[103] Congress has gone part way to that solution: starting in 1997, states must allow recipients of unemployment benefits to elect to have federal income tax withholding at a 15% rate.[104]

Similarly, many problems are created for taxpayers and the IRS when taxpayers simply "forget" to report miscellaneous items of income. No doubt, many taxpayers end up getting a notice from the IRS simply because they forgot to report a couple hundred dollar state income tax refund or a few dollars of interest on an extra savings account. Indeed, such notices must

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classifies a worker as an independent contractor, the business does not need to withhold taxes but must report annual payments of $600 or more to the IRS on an information return. The determination of whether a worker is an employee or independent contractor is based on common law rules that are often unclear and subject to conflicting interpretations. *See, e.g.*, APPROACHES FOR IMPROVING INDEPENDENT CONTRACTOR COMPLIANCE, *supra* note 97, at 1-2.

100 This example is taken from a presentation by Paul Heimer, Coordinator of Volunteer Services, Arlington-Alexandria Coalition for the Homeless, Inc., North Arlington, Virginia. Remarks at the meeting of the Committee on Low-Income Taxpayers of the American Bar Association Section of Taxation (May 14, 1994).

101 I.R.C. §§ 85, 6050B (1994).

102 No doubt, she would have found it "burdensome to make quarterly estimated tax payments." *See, e.g.*, H.R. Rep. No. 826(I), 103d Cong., 2d Sess. 171-72 (1994), *reprinted in* 1994 U.S.C.C.A.N. 3773, 3944.

103 This is what Mr. Heimer suggested. *See supra* note 100.

104 I.R.C. § 3402(p)(2) (1994). This provision was added by the Uruguay Round Agreements Act, Pub. L. No. 103-465, 108 Stat. 4809, 4996-97 (1994). The Act also allows taxpayers who receive Social Security benefits and certain other federal payments to request that the federal agency making the payments withhold federal income taxes from those payments. I.R.C. § 3402(p)(1) (1994).

comprise a significant share of the 33 million penalty notices that the IRS sent to taxpayers in 1994.[105]

Thus, it seems that expanding mandatory withholding to more types of income could simplify the income tax system for many individuals and for the IRS. In that regard, if the tax system had a single "flat" tax rate over a broad range of incomes, withholding at that rate might automatically satisfy the tax liabilities for millions of taxpayers and virtually eliminate the need for them to file returns.[106]

On the other hand, expanding mandatory withholding might compel even more low-income individuals to file tax returns simply to get refunds of over-withheld taxes.[107] For example, a married couple receiving $20,000 of Social Security benefits and $12,000 of interest income in 1996 would have zero taxable income, owe zero income tax, and not have to file an income tax return. With mandatory withholding on interest or Social Security benefits, however, this couple would need to file a return just to recover over-withheld taxes. Thus, while expanding mandatory withholding to more types of income would help some low-income individuals avoid financial hardship at tax time, it would compel other low-income individuals to file returns just to recover their over-withheld taxes.

Consequently, a cautious expansion of withholding seems advisable. Perhaps it would be feasible to extend mandatory withholding to such compensation-like income as unemployment benefits and payments to independent contractors.[108] On the other hand, back-up or voluntary withholding may prove sufficient for other forms of income.

2. *Simplify Returns*

This section identifies a number of statutory changes that would simplify returns for low-income individuals.

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[105] *33 Million Penalty Notices*, WALL ST. J., Apr. 17, 1995, at A12.

[106] *See infra* parts IV.C.2 and IV.C.3.

[107] In fact, over-withholding is already one of the major reasons that low-income individuals have to file returns. Another major reason for low-income individuals to file returns is to collect their earned income credit refunds.

[108] *See* discussion *infra* part IV.B.2.d.

a. *Increase the Standard Deduction and Personal Exemption Amounts, and Repeal or Curtail Certain Itemized Deductions*

Raising the standard deduction and/or personal exemption amounts would raise the income tax thresholds.[109] That would mean that fewer taxpayers would be required to file income tax returns. Of course, this would greatly simplify the tax system for individuals and for the IRS.[110]

Raising the standard deduction would also decrease the number of taxpayers who itemize their deductions. Typically, about 70% of Americans claim the standard deduction and 30% itemize their deductions.[111] Consequently, raising the standard deduction would mean millions fewer complicated tax returns for taxpayers to file and for the IRS to process.

It is also worth noting that repealing any of the many itemized deductions would also reduce the number of individuals who itemize, thereby simplifying their returns. Admittedly, relatively few low-income taxpayers itemize their deductions—only about 10% of those with adjusted gross incomes under $30,000.[112] Still, if the deductions for mortgage interest, state and local taxes, and charitable contributions were repealed,[113] virtually no low-income taxpayers would end up itemizing their deductions. Given the political difficulties of repealing any itemized deduction, Congress might start by repealing the deductions for state and local personal property taxes and the

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[109] It is worth noting that this approach—raising the standard deduction and personal exemptions—is central to many of the flat tax proposals that are more fully discussed later in this Article. *See infra* part IV.C.2.

[110] In raising the standard deduction amounts, due consideration should also be given to fixing the "marriage penalty." For example, in 1996, an unmarried individual can claim a standard deduction of $4,000, but a married couple filing jointly can only claim a standard deduction of $6,700, not $8,000 ($8,000 = 2 x $4,000). In that regard, the Balanced Budget Reconciliation Bill of 1995 that President Clinton vetoed in December included a proposal that would have gradually increased the standard deduction for joint filers until it was twice that for single filers by the year 2005. John Godfrey, *Clinton Keeps Individual Tax Cuts, Targets More Corporate Tax Provisions*, 69 TAX NOTES 1303 (1995); *Comparison of Clinton, Congressional Tax Bills*, 69 TAX NOTES 1064 (1995); H.R. 2491 § 11,002, 104TH CONG. 1st SESS. (1995).

[111] *See supra* part II.A.2.

[112] *Id.*

[113] *See, e.g.*, DEP'T. OF THE TREAS., 2 TAX REFORM FOR FAIRNESS, SIMPLICITY, AND ECONOMIC GROWTH 62–68 (1984) [hereinafter TAX REFORM FOR FAIRNESS] (Treasury Department Report to the President) (proposing the repeal of the deduction for state and local taxes paid).

deductions for unreimbursed employee business and moving expenses.[114] After all, the record-keeping burdens of these deductions on both taxpayers and the IRS often seem disproportionate to the tax savings that result from claiming them.

Alternatively, adding a floor to any of the itemized deductions could reduce the number of itemizers and so simplify their returns. For example, it might be appropriate to allow charitable contribution deductions only to the extent that the individual's contributions exceed two, five, or 10% of the individual's adjusted gross income (AGI).[115] Also, raising the floors on those current itemized deductions that have floors would also reduce the number of itemizers and so simplify their returns.[116]

Another approach would be to replace the current standard deduction with a high personal exemption (e.g. $10,000) and a high percent-of-AGI floor under all of the personal deductions.[117] Still another alternative would be to replace personal exemptions, standard deductions, and perhaps even the earned income credit with a single "support allowance" that increased with the number of dependents and varied with marital status.[118] The point is that reducing the number of itemizers can simplify the tax system for individuals and for the IRS.

b. *Simplify or Replace the Earned Income Credit*

Over the years, the earned income credit has become both more generous and more complicated. For example, in 1996, a qualifying taxpayer with two children may claim an earned income credit of up to $3,556, but the taxpayer needs to file a tax return and taxpayers with children must attach Schedule EIC to receive the credit. Not surprisingly, taxpayer compliance and participation in the earned income credit program have become major concerns.[119] This Part discusses some of the recent proposals to simplify or replace the credit.[120]

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114 *Cf.* Joseph M. Dodge, *A Democratic Tax Manifesto*, 66 TAX NOTES 1313, 1321–22 (1995) (analyzing deductions for employee business expenses and moving expenses).

115 *See, e.g.*, TAX REFORM FOR FAIRNESS, *supra* note 113, at 69; Dodge, *supra* note 114, at 1319–20.

116 For example, under I.R.C. § 213 (1994), medical expenses are deductible only to the extent that they exceed 7.5% of AGI. *See also id.* § 67 (miscellaneous itemized deductions) and § 165(c)(3), (h) (casualty losses).

117 Dodge, *supra* note 114, at 1317–19; *see also* McMahon, *supra* note 87, at 473–75.

118 *See* Schenk, *supra* note 87, at 144–46.

119 *See generally* Alstott, *supra* note 95; Anne L. Alstott, *The Earned Income Tax Credit and Some Fundamental Institutional Dilemmas of Tax-Transfer Integration*, 47 NAT'L TAX J. 609 (1994); Caballero, *supra* note 5; Robert H. Haveman & John K. Scholz, *Transfers, Taxes, and Welfare Reform*, 47 NAT'L TAX J. 417 (1994); John K. Scholz, *The*

i. *Simplify the Earned Income Credit*

One reform idea would be to modify the 1040 forms so that taxpayers with children would no longer have to file a Schedule EIC in order to claim the credit. It would also make sense to simplify some of the earned income credit eligibility requirements. For example, it might make sense to simplify the definition of "qualifying child" or make the definitions of "dependent" and "qualifying child" more compatible.[121]

Another reform would be to simplify the definition of "earned income" that is used to determine the amount of an individual's earned income credit. The current definition of "earned income" includes several items that are excluded from gross income and that are not reported on W-2 or 1099 forms. Most taxpayers eligible for the credit have none of these items, but both taxpayers and the IRS must try to keep track of them. Consequently, one simplification would be to include in "earned income" only those items includable in gross income. Then the credit could be readily computed from information already available on W-2 or 1099 forms and on tax returns.

For that matter, it might make sense to limit the definition of "earned income" to "wages." Under current law, the high level of earned income credit benefits available can actually provide an incentive for low-income individuals to report fictitious amounts of earnings. Limiting the definition to "wages" would help curb that abuse.

Another improvement might be to simplify or repeal the advance payment option. Under current law, eligible individuals can claim a portion of their earned income credit during the year through increases in their paychecks. To receive their so-called advance payment, individuals must provide their employers with IRS Form W-5, Earned Income Credit Advance Payment Certificate,[122] but less than 1% of eligible individuals bother to do this.[123] Incorporating Form W-5 into the standard Form W-4, Employer's Withholding Allowance Certificate, might increase the use of the advance payment option.

Earned Income Tax Credit: Participation, Compliance, and Antipoverty Effectiveness, 47 NAT'L TAX J. 63 (1994); Yin et al., *supra* note 66; George K. Yin, *Summary of EITC Conference Proceedings*, 11 AM. J. TAX POL'Y 299 (1994).

120 This part draws heavily from Yin et al., *supra* note 66.

121 *See infra* part IV.B.2.e.

122 I.R.C. § 3507 (1994); Treas. Reg. § 31.3507-2.

123 GENERAL ACCOUNTING OFFICE, EARNED INCOME TAX CREDIT: ADVANCE PAYMENT OPTION IS NOT WIDELY KNOWN OR UNDERSTOOD BY THE PUBLIC 3 (GAO/GGD-92-26) (1992); Ron Donmoyer, *Few Taxpayers Taking Advantage of Advance Earned Income Credit*, 66 TAX NOTES 1765 (1995).

Alternatively, it might be better to eliminate the advance payment option altogether.[124]

Finally, although not strictly a simplification issue, some effort should be made to fix the so-called "marriage penalty" inherent in the earned income credit. For example, if a worker has two children and $10,000 of earned income, she can claim an earned income credit of $3,556 in 1996. Unfortunately, if she marries another $10,000 a year worker with two children (also eligible for a $3,556 credit), together they can claim only one credit of $1,789—that's a marriage penalty of more than $5,000.

On the other hand, if a childless worker earning $10,000 per year marries a nonworker with two children, together the couple can claim an earned income tax credit of $3,556 in 1996. That's a marriage bonus of more than $3,556, as neither was eligible for the credit before they got married. Such marriage penalties and bonuses create complexity and compliance problems for low-income taxpayers and for the IRS. Unfortunately, there is no easy way to restructure the current credit and even less guarantee that the restructured credit would actually be simpler.[125]

ii. *Replace the Earned Income Credit*

Given the complexity of the earned income credit, it is worth considering some alternative approaches for distributing similar benefits to low-income individuals. One approach would be to replace the earned income credit with alternative tax provisions that could provide similar benefits to low-income individuals. In that regard, much of the complexity of the current system results from imposing Social Security taxes on every dollar of earned income, and then using the earned income credit to offset taxes for those low-income workers.

It would be a lot simpler if the federal tax system did not collect Social Security taxes from low-income individuals in the first place. One option would be to add standard deductions and personal exemptions to the Social Security tax system.[126] Another option would be to exempt the first $5,000 or $10,000

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[124] Employers would also appreciate this simplification.

[125] *See, e.g.*, Alstott, *supra* note 95, at 559–64.

[126] *See, e.g.*, George F. Break, *Social Security as a Tax*, *in* THE CRISIS IN SOCIAL SECURITY: PROBLEMS AND PROSPECTS 107, 121–22 (Michael J. Boskin ed. 1977); Jonathan B. Forman, *Using Refundable Tax Credits to Help Low-Income Families*, 35 LOY. L. REV. 117, 138–39 (1989); Michael J. Graetz, *The Troubled Marriage of Retirement Security and Tax Policy*, 135 U. PA. L. REV. 851, 865–68 (1987).

of earnings by any worker from Social Security taxation.[127] While, under either or these two options, some special rules would be needed to ensure that the proper amount of tax is collected from workers with more than one job during the year,[128] millions of other low-income workers would simply no longer need to file tax returns.[129]

Of course, much of the current earned income credit benefit seems to be intended to provide income assistance to families with children. But it could be simpler to provide that type of family benefit through a refundable child tax credit or a refundable family allowance tax credit based solely upon the number of children in the family.[130]

A second alternative approach to the current earned income credit, would be to replace it with a tax benefit that reaches low-income workers through

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[127] *See* Yin et al., *supra* note 66, at 280–83; George K. Yin & Jonathan B. Forman, *Redesigning the Earned Income Tax Credit Program to Provide More Effective Assistance for the Working Poor*, 59 TAX NOTES 951, 957–59 (1993); *see also* Caballero, *supra* note 5, at 464–68 (proposing a system of graduated Social Security taxes with a base exemption at the lowest levels of income).

[128] Allocating the benefit on a monthly or weekly basis would solve the problem for workers with consecutive jobs. For example, a $5,200 Social Security exemption could be prorated so as to exclude the first $100 per week of wages from Social Security taxation. Also, workers could be asked to indicate multiple employment on Form W-4, Employer's Withholding Certificate, and any remaining problems could be reconciled on annual tax returns.

[129] One objection to creating a Social Security tax exemption might be its cost, but the lost revenues could be made up in a variety of ways. The revenue lost from a Social Security tax exemption could be recovered, in part, from the repeal of the current earned income credit and, in part, by raising the Social Security tax rate on earnings over the exempt amount.

Some also might object that a Social Security tax exemption would decouple Social Security taxes and benefits. On this view, Social Security taxes are said to "buy" future benefits and as such are not really taxes at all. But the current earned income credit has *already* decoupled Social Security taxes and benefits. For that matter, the link between Social Security taxes and benefits has always been pretty loose: benefits vary dramatically based on such factors as age, income, and marital status. *See, e.g.*, Jonathan B. Forman, *Promoting Fairness in the Social Security Retirement Program: Partial Integration and a Credit for Dual-Earner Couples*, 45 TAX LAW 915, 926–48 (1992). Finally, Social Security benefits could continue to be based on each individual's work history, even if a portion of the wages earned by that individual were exempt.

[130] *See, e.g.*, NAT'L COMM'N ON CHILDREN, BEYOND RHETORIC: A NEW AMERICAN AGENDA FOR CHILDREN AND FAMILIES 80–89 (1991) (calling for a $1,000 per child refundable tax credit); *see also* Yin et al., *supra* note 66, at 280–86.

their employers.[131] For example, an employer tax credit could provide a tax benefit to the employers of low-wage workers. According to standard economic analysis, these tax benefits would pass through to the workers in the form of relatively higher wages. Consequently, an employer tax credit would end up helping most of the same low-income individuals currently targeted by the current earned income credit. Yet an employer tax credit would be significantly easier to administer than the current earned income credit, if only because there are far fewer employers than low-income workers.

A third approach would be to combine the earned income credit with other income transfer programs like food stamps, Aid to Families with Dependent Children (AFDC), and Supplemental Security Income (SSI).[132] After all, the earned income credit is just one of dozens of federal programs that provide income assistance to low-income individuals. The multiplicity of these programs has resulted in complexity, inequity, and high administrative costs. Consequently, it might make sense to combine the earned income credit with other federal welfare programs into a single, comprehensive income transfer program that could be administered by a single agency. The agency might even turn out to be the IRS, although the Department of Health and Human Services or the Social Security Administration may be more likely. Alternatively, the revenues now used for the earned income credit could be bundled together with the appropriations for other welfare programs and revenue-shared out to state welfare agencies.[133]

c. *Create a $500 or $1,000 Per Year Exclusion for Interest, Dividends, Gains, and Other Miscellaneous Items of Income*

Another way to simplify income tax returns for low-income individuals would be to add an exclusion for some modest amount of noncompensation income. It just does not make sense to require millions of individuals to report negligible amounts of interest, dividends, gains, state tax refunds, and other miscellaneous items of income and then make the IRS dispute returns that miss

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[131] *See, e.g.*, Jonathan B. Forman, *Improving the Earned Income Credit: Transition to a Wage Subsidy Credit for the Working Poor*, 16 FLA. ST. U. L. REV. 41 (1988); James E. Williamson & Francine J. Lipman, *The New Earned Income Tax Credit: Too Complex for the Targeted Taxpayers*, 57 TAX NOTES 789 (1992); Yin et al., *supra* note 66, at 280–86.

[132] *See, e.g.*, Jonathan B. Forman, *Administrative Savings from Synchronizing Social Welfare Programs and Tax Provisions*, 13 J. OF NAT'L ASS'N OF ADMIN. L. JUDGES 5 (1993); Jonathan B. Forman, *Synchronizing Social Welfare Programs and Tax Provisions*, 59 TAX NOTES, 417 (1993).

[133] *Cf.*, Jeffrey L. Katz, *House Passes Welfare Bill; Senate Likely to Alter It*, 53 CONG. Q. WEEKLY REP. 872 (1995).

a few dollars of such income. One option would be to let taxpayers exclude from gross income up to $500 or $1,000 per year of interest, dividends, gains, state tax refunds, and other miscellaneous items of income.[134]

In that regard, reconsider Table 6, above. Among other things, Table 6 shows the various types of income that low-income individuals received in 1993. For example, of the almost 45 million taxpayers with adjusted gross income below $15,000 in 1993, only about 5 million received any dividends, and those received an average of about $1,500 of dividends each.[135] Undoubtedly, that means that many of those 5 million received less than $500 or $1,000 of dividends.

Similarly, less than 17 million taxpayers with adjusted gross income below $15,000 in 1993 received any interest income, and those received an average of about $1,360 of interest.[136] Again, that means that many of those 17 million received less than $500 or $1,000 of interest.

All in all, Table 6 suggests that there are millions of individuals whose interest, dividends, gains, state tax refunds, and other miscellaneous items of income do not aggregate to more than $500 or $1,000 per year. Allowing an exclusion for up to $500 or $1,000 of such investment and miscellaneous income would reduce the record-keeping and filing burdens on these taxpayers and on the IRS.[137] Similar compliance benefits have flowed from the standard deduction,[138] the 2% floor on miscellaneous itemized deductions,[139] and the repeal of the deduction for sales taxes.[140]

Of course, allowing every taxpayer an exclusion for up to $500 or $1,000 of interest, dividends, gains, state tax refunds, and other miscellaneous items of income could have serious revenue and distributional implications.[141] Still,

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[134] Former I.R.C. § 116 provided an exclusion of up to $100 of dividends received by individual taxpayers ($200 for married couples). It was repealed by the Tax Reform Act of 1986, in part to offset the revenue losses from lowering tax rates.

[135] $7,821,074,000 of dividends divided over 5,277,264 returns equals $1,482.

[136] $22,822,663 of interest divided over 16,823,648 returns equals $1,357.

[137] resumably, the exclusion would not apply to wages, salaries, commissions, fees, and other forms of compensation for services.

[138] I.R.C. § 63(c) (1994).

[139] *Id.* § 67.

[140] Former I.R.C. § 164(a)(4) (1982), *repealed by* Tax Reform Act of 1986, Pub. L. No. 99-514, § 134(a)(1), 100 Stat. 2085, 2116.

[141] The exclusion could be targeted to low-income individuals; however, almost any kind of targeting (e.g., a phase-out) would create more complexity for other taxpayers. Accordingly, it would probably be simplest to have an across-the-board exemption, and use tax rates or other mechanisms to raise lost revenue and address distributional concerns. Among the distributional concerns worth noting, however, is that the exclusion would favor

such an exclusion could dramatically simplify the tax system for the IRS and for those millions of taxpayers who now must keep track of negligible amounts of such income.[142]

d. *Reclassify More Workers as Employees, Rather Than Independent Contractors*

Low-income workers face several problems because of the federal tax distinction between "employees" and "independent contractors." At the outset, some low-income workers may have difficulty in properly determining whether they are "employees" or "independent contractors" for tax purposes. In that regard, many analysts have offered recommendations about how to clarify the IRS's worker classification rules, and such clarification could help simplify the tax system for low-income individuals, employers, and the IRS.[143]

But being classified as an "independent contractor" causes two far more significant problems for low-income workers. First, low-income independent contractors (e.g., taxi drivers) will often find it difficult to save enough money during the year to meet their income and Social Security taxes the following April 15.[144] Second, the tax returns of low-income independent contractors generally will be far more complicated than those of low-income employees (e.g., Schedules C and SE).[145]

One solution would be to change the IRS's worker classification rules so that virtually all low-income workers are classified as "employees." That would make their compensation subject to the ordinary wage withholding rules. As a result, they would avoid the financial hardship that often results from the absence of withholding on payments to independent contractors, and they would be able to file the simpler income tax returns as typical employees.

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individuals with existing investments (in particular, the elderly) over individuals without investments.

142 Moreover, by reducing the tax imposed on up to $500 or $1,000 of investment income, the exclusion would act as a powerful savings incentive.

143 *See, e.g., An Updated Review of Tax Administration Problems Involving Independent Contractors: Hearing Before the Subcomm. on Commerce, Consumer, and Monetary Affairs of the House Comm. on Government Operations*, 103d Cong., 1st Sess. 129 (1993) (statement of James E. Merritt, Council Director, Section on Taxation, American Bar Association).

144 *See supra* part IV.B.1.c.

145 Also, independent contractors must keep track of their business expenses, as these are deductible in computing adjusted gross income. I.R.C. § 62(a)(1) (1994). On the other hand, relatively few employees get the benefit of deducting their employee business expenses. *Id.* §§ 62(a)(2), 67.

Another alternative would be to require that taxes be withheld from payments to low-income workers who act as independent contractors.[146] While low-income independent contractors would still have to file relatively complicated returns, they would avoid the financial hardship that can result from underwithholding.

e. *Simplify and Coordinate the Definitions of "Child" and "Dependent"*

Low-income individuals can also have difficulty determining the number of dependents they can claim and whether those dependents are qualifying individuals for head of household status, surviving spouse status, the earned income credit, and the dependent care credit.[147] In that regard, many analysts have recommended simpler and more uniform definitions of such terms as "child" and "dependent."[148] Such changes could be especially significant for low-income taxpayers.

The complexity in this area does seem excessive. For example, in order to claim another person as a "dependent" for purposes of the personal exemption, the taxpayer must generally show that the other is: (1) related to the taxpayer (relationship test); (2) that the taxpayer has provided more than half of the support for the other (support test); (3) that the other's gross income does not exceed the amount of the exemption (gross income test); and (4) that the other does not file a joint return (joint return test).[149] On the other hand, in order to claim a "qualifying child" for purposes of the earned income credit, the taxpayer must have: (1) a child (relationship test); (2) who is under the age of 19 or a full-time student under the age of 24 (age test); and (3) the child must have the same principal place of abode as the taxpayer for more than one-half of the year (residence test).[150] It is no wonder that so many low-income taxpayers pay to have their tax returns prepared: it takes the Code, a dictionary, and a tax advisor to figure out conditions such as these.

With respect to the dependency exemption, one option would be to simplify the support test and to repeal the relationship, adjusted gross income, and joint return tests.[151] Another approach would be to conform the

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[146] APPROACHES FOR IMPROVING INDEPENDENT CONTRACTOR COMPLIANCE, *supra* note 97, at 4-5.

[147] *Compare* I.R.C. § 152 (1994) *with id.* §§ 2(b), (c), 32, 21 respectively.

[148] This part generally follows Schenk, *supra* note 87, at 130-35.

[149] I.R.C. §§ 151, 152 (1994).

[150] *Id.* § 32(c)(3).

[151] *See, e.g.*, Schenk, *supra* note 87, at 130-35; Deborah H. Schenk, *Simplifying Dependency Exemptions: A Proposal for Reform*, 35 TAX LAW. 855, 860-66 (1982). Of note, the ABA is already on record with a legislative recommendation to simplify the

dependency exemption tests more closely to those for a "qualifying child" under the earned income credit.[152] Basically, this would require replacing the current support requirement with a residency requirement. The point is that significant simplification could be achieved by conforming the various definitions of "dependent" and "qualifying child" in the Internal Revenue Code.

f. *Simplify the Determination of Marital Status and Filing Status or Move to Individual Filing*

Low-income individuals can also have difficulty determining their filing status. At the outset, an individual must determine her marital status. Only then can she determine which of five filing statuses is applicable: married filing jointly, married filing separately, surviving spouse, head of household, or single. Much of the complexity in the individual income tax could be eliminated if these determinations were simplified.[153]

Most of the complexity in establishing marital status results because certain abandoned spouses who are married for state law purposes can qualify as unmarried for federal tax purposes. The rules are complicated, and one approach would be to simplify those rules. For example, one proposal would make the only requirement to qualify as an abandoned spouse be that the individual be separated from her spouse for the entire year.[154]

The definitions of head of household and surviving spouse also could be simplified. It would be simpler if qualifying for head of household or surviving spouse status did not require that the individual "maintain" a "household" for a "qualifying individual." Instead, perhaps it should be sufficient if the individual

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dependency exemption along these lines and to provide a uniform definition of "child." ABA Tax Section Recommendation No. 1986-1. This recommendation was ultimately adopted by the ABA Tax Section on Feb. 1, 1986 and by the ABA House of Delegates on August 9, 1986. Schenk, *supra* note 87, at 130 n.29.

An even more radical approach would be to totally restructure the personal exemption so that it is taken either by the taxpayer or by the taxpayer's parent, but no one else. Schenk, *supra* note 87, at 147–48.

152 GENERAL ACCOUNTING OFFICE, TAX ADMINISTRATION: ERRONEOUS DEPENDENT AND FILING STATUS CLAIMS (GAO/GGD-93-60) (1993); Yin et al., *supra* note 66, at 270–74.

153 *See generally* Schenk, *supra* note 87, at 135–40.

154 *Id.* at 136.

simply has a dependent.[155] Even more simplification would be achieved if surviving spouse and head of household statuses were eliminated.[156]

Still more simplification could be achieved by having each individual, married or unmarried and with or without children, file as individuals under a single tax rate schedule.[157] This would virtually eliminate questions about marital status and the so-called marriage penalty of the current system.[158] To keep tax returns simple, spouses could be allowed to file separately on the same return.[159] For that matter, low-income couples could be allowed to compute their taxable income on an aggregate basis, and simply allocate it between them on a 50-50 basis.

g. *Repeal the Presidential Election Campaign Checkoff*

Another way to simplify income tax returns would be to repeal the Presidential Election Campaign Fund checkoff.[160] The checkoff clutters up individual income returns.[161] Consequently, repealing the checkoff would

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155 *Id; cf., id.*, at 143–44 (proposing the same approach to simplifying the dependent care credit).

156 *Id.* at 138–39.

157 *See, e.g.*, Dodge, *supra* note 114, at 1316; Pamela Gann, *Abandoning Marital Status as a Factor in Allocating Income Tax Burdens*, 59 TEX. L. REV. 1 (1980); Marjorie E. Kornhauser, *Love, Money, and the IRS: Family, Income Sharing, and the Joint Return*, 45 HASTINGS L. J. 63 (1993); Edward J. McCaffery, *Taxation and the Family: A Fresh Look at Behavioral Gender Biases in the Code*, 40 UCLA L. REV. 983 (1993); Lawrence Zelenak, *Marriage and the Income Tax*, 67 S. CAL. L. REV. 339 (1994).

158 Depending on the way that income would be allocated between spouses, there still could be differing tax liabilities for married and unmarried couples.

159 For example, Arkansas allows married couples to file their income tax returns this way.

160 I.R.C. § 6096 (1994); *see* Victor Thuronyi, *Simplification for the Average Taxpayer*, 40 TAX NOTES 183, 187-89 (1988). Alternatively, the checkoff could be removed from forms 1040EZ and 1040A or, at least, moved to a supplemental schedule. Still another possibility would be to allow each taxpayer to make a permanent (but revocable) election on an income tax schedule or on a form like Form W-4, Employer's Withholding Allowance Certificate.

161 Under current law, every individual who has an income tax liability can check a tax return box to designate three dollars to be paid to the Presidential Election Campaign Fund (up to six dollars for married couples). The funds so designated are made available to various presidential election campaigns. I.R.C. § 9004 (1994). The checkoff was apparently designed to provide each individual taxpayer with a choice about whether or not to help finance Presidential election campaigns.

simplify tax returns for both taxpayers and the IRS.[162] Repealing the Presidential checkoff would be especially helpful if the tax system moves to a return-free system.[163]

C. *Fundamentally Revamp the Current System*

Even before the 1994 Congressional elections, the idea of fundamentally reforming the federal tax system was starting to take hold. According to a Wall Street Journal/NBC News poll taken in August 1994, even then 37% of Americans favored "complete overhaul" of the tax system.[164] Since that time, disillusionment with the current tax system surely has increased, and a variety of sweeping changes to the system have been recommended by political leaders of all stripes.

This Subpart considers three approaches to fundamentally change the current tax system: (1) integrating the income and Social Security taxes; (2) shifting to a flat tax, possibly with a consumption tax base; and (3) moving to a return-free system. Any one of these approaches could result in significant simplification for low-income individuals.

1. *Integrate the Income and Social Security Taxes into a Comprehensive Income Tax or into an Earnings Tax*

Much of the complexity of the current federal tax system is the result of the fact that there are two major taxes imposed on individuals: income taxes and Social Security taxes. Under current law, Social Security taxes are collected on every dollar of earned income, and the income tax system uses the earned income credit to refund at least part of those taxes to millions of low-income workers. As previously discussed, it would be a lot simpler if the federal tax system did not collect Social Security taxes from low-income individuals in the first place, and one approach would be to add an exemption to the Social Security tax system.[165]

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162 If Congress remains committed to public financing of Presidential election campaigns, it can replace the checkoff with direct appropriations to the Presidential campaign election fund. In that regard, prior to 1994, each individual taxpayer could designate just one dollar to be paid to the Presidential Election Campaign Fund (up to two dollars per couple). In response to a projected shortfall in the Fund, Congress recently raised the amount to its current three-dollar per taxpayer level. Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, § 13,441, 107 Stat. 312, 567–68 (1993).

163 *See infra* part IV.C.3.

164 Tom Herman, *Tax Report*, WALL ST. J., Aug. 3, 1994, at A1.

165 *See supra* part IV.B.2.b.

a. *A Comprehensive Income Tax*

A more comprehensive approach would be to combine the individual income and Social Security taxes into a single comprehensive income tax.[166] Individuals with incomes below some poverty threshold would be exempt from tax, and tax rates could be increased in order to raise the same amount of revenue. In effect, there would be a single, higher-yield income tax instead of the current bifurcated tax system. Such an integrated system would be simpler to administer than the current system. Literally millions of low-income individuals would no longer have to file tax returns simply to recover over-withheld taxes.

Moreover, such an integrated tax system could have a logical tax rate structure, as opposed to the rollercoaster rate structure of the current tax system. Now, an individual's effective marginal tax rate depends upon an almost random combination of income tax rates, Social Security tax rates, and the phaseouts of the earned income credit, the dependent care credit, personal exemptions, and other tax benefits.[167] On the other hand, an integrated tax system might be designed to impose, say, no tax on income below some poverty threshold, a 25% tax rate on income from that threshold up to $100,000 of income, and a 40% tax rate on income over $100,000. Alternatively, such a system might be designed to impose no tax on income up to some poverty threshold and a 30% "flat" tax rate on income above that threshold. Either of these alternatives would be modestly progressive, but in a logical, easy-to-understand way.[168]

b. *An Earnings Tax*

The opposite approach would be to combine the income and Social Security taxes into a single tax on earned income. In effect, there would be a single, higher-yield Social Security tax instead of the current bifurcated tax system. This approach could result in substantial simplification: after all, it

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[166] *See, e.g.*, JOSEPH A. PECHMAN ET AL., SOCIAL SECURITY: PERSPECTIVES FOR REFORM 189-91 (1968); *see also* Forman, *supra* note 129, at 955-57; Robert Eisner, *Make Taxes Fair, Not Flat*, WALL ST. J., Apr. 11, 1995, at A20.

[167] *See, e.g.*, ARTHUR P. HALL, TAX FOUNDATION SPECIAL REPORT: INDIVIDUAL EFFECTIVE TAX RATES IN THE UNITED STATES (June 1994) (*available in* LEXIS, *at* 94 TNT 126-75).

[168] Moreover, a little tinkering with these rates and brackets could insure that the integrated tax system would yield the same amount of revenue as the current bifurcated system.

only takes a handful of Code sections to explain the Social Security payroll and self-employment taxes, yet it takes hundreds of sections to explain the income tax. Granted it would become more important to differentiate between earned income and investment income, but all of the income tax rules that determine depreciation, capital gains, and the timing of investment income would disappear.

On the other hand, many would view an earnings tax as inequitable. Theoretically, a progressive rate structure could make an earnings tax moderately progressive. In reality, however, many high-income investors would completely avoid an earnings tax, and that would not set well with middle-class workers. Also, because earned income is just one form of income, tax rates must be higher under an earnings tax than under an income tax to raise the same amount of revenue.[169]

2. *Shift to a Flat Tax, Perhaps with Consumption as the Tax Base*

Another fundamental change would be to replace all or a part of the current federal tax with some form of "flat tax." For example, House Majority Leader Richard K. Armey (R-Texas) recently proposed legislation that would replace the current income and Social Security taxes with a flat tax on earned income.[170] Under this proposal, an individual taxpayer would total her earned income, subtract a large personal allowance ($10,700 for a single individual; $21,400 for a married couple), plus deductions of $5,000 per child, and then pay a flat 17% rate on the remainder.[171]

The Armey proposal is representative of the type of flat tax proposals before Congress, virtually all of which would simplify the operation of the tax

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[169] Similar concerns are often expressed about consumption taxes, as these often end up looking a lot like taxes imposed only on earnings. *See, e.g.*, Jane G. Gravelle, *The Flat Tax and Other Proposals: Who Will Bear the Tax Burden?*, 69 TAX NOTES 1517 (1995).

[170] H.R. 2060, 104d Cong., 1st Sess. (1995); *see also* S. 1050, 104th Cong., 1st Sess. (1995) (companion bill of Sen. Richard Shelby, R-Ala.). Armey's proposal is modeled on a plan that economists Robert Hall and Alvin Rabushka proposed in the early 1980's. ROBERT E. HALL & ALVIN RABUSHKA, LOW TAX, SIMPLE TAX, FLAT TAX (1983); *see also* ROBERT E. HALL & ALVIN RABUSHKA, THE FLAT TAX (2d ed. 1995).

[171] There is some dispute about whether the flat rate can be so low (or, alternatively the personal and child allowances so high), and there is also concern about the distributional effects of the Armey proposal. *See, e.g.*, Office of Tax Analysis, U.S. Treas. Department, *'New' Armey-Shelby Flat Tax Would Still Lose Money Treasury Finds*, 70 TAX NOTES 451 (1996); Barbara Kirchheimer, *Armey Flat Tax Plan Panned by Treasury*, 65 TAX NOTES 655 (1994).

system for low-income individuals.[172] Indeed, proponents of flat taxes often argue that most individuals would be able to file their tax returns on a postcard.

Of special note, in January of 1996 the National Commission on Econnomic Growth and Tax Reform, chaired by former Congressman Jack Kemp, released a report recommending replacing the current federal tax system with "a new simplified tax system for the 21st century: a single low rate, taxing income only once with a generous personal exemption and full deductibility of the payroll tax for America's working men and women."[173]

a. *Flat Taxes*

By the term "flat tax," analysts usually mean to refer to a tax system with virtually a single tax rate. The underlying tax base could be either income or consumption. The key is that above a certain threshold, a single tax rate applies. To keep the single rate low, most flat tax plans would get rid of many, if not all, itemized deductions.

For example, a simple flat tax might provide a basic exemption of $10,000 per person, and then tax all income above $10,000 per person at a 20% rate. Such a tax would actually be moderately progressive, not flat: effective tax rates go up as income goes up.[174] Someone making $10,000 would pay no tax (0% average rate); someone making $20,000 would pay only $2,000 in taxes (10% average rate); someone making $100,000 would pay $18,000 in taxes (18% average rate); and so on. Moreover, the higher the basic exemption, the more progressive a "flat tax" can be.

b. *A Consumption Tax Base*

For a variety of reasons, a number of analysts have argued for moving to a consumption tax base instead of an income tax base. Consumption taxes come in a variety of forms. One might, for example, replace the current income tax

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[172] *See* Barbara Kirchheimer, *House Talks of Flattening the Code and the 'Contract' Takes a Hit*, 66 TAX NOTES 295 (1995).

[173] NATIONAL COMMISSION ON ECONOMIC GROWTH AND TAX REFORM, UNLEASHING AMERICA'S POTENTIAL: A PRO-GROWTH, PRO-FAMILY TAX SYSTEM FOR THE 21ST CENTURY (1996), *reprinted in* 70 TAX NOTES 413, 416 (1996); *see also* William G. Gale, *The Kemp Commission and the Future of Tax Reform*, 70 TAX NOTES 717 (1996); Fred Stokeld et al., *Kemp Tax Commission Calls for Flat Tax*, 70 TAX NOTES 335 (1996).

[174] *See, e.g.*, Joseph Bankman & Thomas Griffith, *Social Welfare and the Rate Structure: A New Look at Progressive Taxation*, 75 CAL. L. REV. 1905 (1987).

with a national sales tax.[175] Alternatively, one might replace the income tax with some form of value-added tax (VAT).[176] Finally, one might replace the current income tax with some type of consumed income tax.[177]

Supporters of consumption taxes usually argue that they will encourage investment and so promote growth. Supporters also argue that consumption taxes hold the promise of collecting taxes from those who currently can evade personal taxes. For example, drug dealers are not known to properly report and pay their income taxes, but their purchases of cars and goods can get snared by a sales tax. Also, many types of consumption tax can avoid the complicated income tax rules needed to determine depreciation, capital gains, and the timing of investment income.

Opponents of consumption taxes usually object that consumption taxes are more regressive than income taxes.[178] Also, because a consumption tax base is theoretically smaller than an income tax base, tax rates must be higher under a consumption tax than under an income tax to raise the same amount of revenue. Opponents are also quick to point out that consumption taxes in the real world

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[175] Laurence J. Kotlikoff, *The Economic Impact of Replacing Federal Income Taxes with a Sales Tax*, Apr. 13, 1993, *available in* LEXIS, Fedtax Library, TNT file, at 93 TNT 83-63. Kotlikoff's National Sales Tax would be paid at the cash register by all consumers when they purchased goods and services from retail establishments. Sales of all goods and services would be taxed at the same rate. The tax would replace all federal income taxation. In the short run, the rate of the proposed national sales tax would be 17%; however, Kotlikoff believes that over time the rate could fall to 11%.

[176] *See, e.g.*, AMERICAN BAR ASSOCIATION SECTION OF TAXATION, VALUE-ADDED TAX: A MODEL STATUTE AND COMMENTARY (1989); DEP'T OF THE TREAS., 3 TAX REFORM FOR FAIRNESS, SIMPLICITY, AND ECONOMIC GROWTH (1984) (Treasury Department Report to the President).

[177] *See, e.g.*, DAVID F. BRADFORD AND THE U.S. TREAS. TAX POLICY STAFF, BLUEPRINTS FOR BASIC TAX REFORM (2d ed. 1984). The Unlimited Savings Allowance (USA) proposal promoted by Senators Pete V. Domenici (R-N.M.) and Sam Nunn (D-Ga.) is an example of a current proposal for a consumed income tax. Under the USA proposal, individuals would compute their income pretty much as they do today, but they would be allowed to deduct their savings and generous personal exemptions, and net income would be taxed at progressive rates. The approach is similar to having a completely unlimited Individual Retirement Account. *See generally* Alliance USA, *Unlimited Saving Allowance (USA) Tax System*, 66 TAX NOTES 1485 (1995); Pete V. Domenici, *The Unamerican Spirit of the Federal Income Tax*, 31 HARV. J. ON LEGIS. 273 (1994). *See also* S. 2160, 103d Cong. 2d Sess. (1994) (The Comprehensive Tax Restructuring and Simplification Act of 1994, a/k/a "Danforth-Boren," introduced by former Senators John C. Danforth, R-MO, and David L. Boren, D-OK).

[178] Of course, it is certainly possible to have a progressive consumed income tax. *See, e.g.*, Michael J. Graetz, *Implementing a Progressive Consumption Tax*, 92 HARV. L. REV. 1575 (1979).

(i.e., European VATs) are every bit as complicated as the current federal income tax and that a pure income tax stacks up pretty well against anybody's idea of a pure consumption tax.

In any event, moving to a consumption tax base does not automatically simplify the tax system for low-income individuals.[179] Just as an income tax can be either simple or complicated, a consumption tax can also be either simple or complicated. For example, simplifications like flat rates, high exemptions, and limited itemized deductions could fit as well in an income tax as in a consumed income tax.

Still, to the extent that the income tax could be replaced by a VAT or national sales tax that collects taxes from just 10 to 20 million producers and sellers, there would certainly be an opportunity to simplify the federal tax system for low-income taxpayers. On the other hand, new complexities would result if refundable tax credits or alternative welfare programs were needed to offset the higher prices that would invariably result.[180] All in all, whether or not a given consumption tax alternative will simplify the tax system for low-income individuals will depend on its design.

3. *Move to a Return-Free or Final Withholding System*

Another way to simplify the tax system for low-income taxpayers would be to move to either a return-free or final withholding tax system.[181] Under a return-free system, the IRS would prepare tax returns for individual taxpayers based on information reports received from employers and other taxpayer income sources. Under a final withholding system, the amounts withheld from employers and other income sources becomes the tax, thus eliminating the need for many taxpayers to file tax returns. These are discussed in turn.

a. *A Return-Free System*

Pursuant to the Tax Reform Act of 1986, the IRS explored the feasibility of moving to a return-free system.[182] Under the return-free tax system that the IRS envisioned in its 1987 report, taxpayers could elect to have the IRS compute their tax liabilities and prepare their returns. The election would be

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[179] *See, e.g.*, Fleming, *supra* note 88; George K. Yin, *Accommodating the "Low-Income" in a Cash-Flow or Consumed Income Tax World*, 2 FLA. TAX REV. 445 (1995).

[180] For example, under a VAT or sales tax, the prices of goods purchased by low-income individuals would increase to reflect the new taxes paid by producers and sellers.

[181] *See generally* INTERNAL REVENUE SERVICE, CURRENT FEASIBILITY OF A RETURN-FREE TAX SYSTEM (1987); OPPORTUNITIES TO REDUCE TAXPAYER BURDENS, *supra* note 73.

[182] INTERNAL REVENUE SERVICE, *supra* note 181.

available to most Form 1040EZ and Form 1040A filers and to Form 1040 filers with relatively simple returns, some 55 million taxpayers in all.

Starting in January of each year, a taxpayer would initiate the process by submitting a signed postcard containing the basic information needed to process a return (such as name, address, and Social Security number, filing status, and number of dependents). The IRS would then prepare a tax return based on information and withholding reports received from employers and other taxpayer income sources. Starting in early March, the IRS would begin mailing returns to taxpayers, along with a refund or a bill. If the taxpayer disagreed with the amounts shown on the return, they could return it to the IRS for adjustment. All taxpayers would remain responsible for the validity of their returns.

For a variety of reasons, the IRS concluded that it was not feasible to implement this return-free system. In truth, the IRS system was not really "return-free" rather, at a taxpayer's election, the burden of preparing the return would shift from the taxpayer to the IRS. Taxpayers would save some time filing their returns (10 minutes for a 1040EZ filer and 30 minutes for a 1040 filer), but many would have to wait longer to get their refunds.[183]

Also, the program would increase the burdens on the IRS and on employers and other filers of information documents. To generate tax returns, the IRS would need to timely receive, verify, and post 970 million wage and information documents. And the IRS estimated that it would cost over one billion dollars and require about 17,000 additional staff to implement the program. Moreover, the program would burden employers and other payers: they would have to file their information returns with the IRS by January 31, rather than February 28.

With ever-expanding IRS computer capabilities, it may become feasible for the IRS to move to a return-free system in the future, and further consideration is merited. On the other hand, the return-free tax system envisioned by the IRS would increase the agency's work load just when the goal should be to reduce the number of tax returns processed.[184]

b. *A Final Withholding System*

Final withholding tax systems are similar to return-free systems, except that they rely more heavily on withholding.[185] Final withholding systems have

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[183] *Id.* at 8. Indeed, many would not receive their refunds until April and for some, this might come too late to timely prepare their state income tax returns. *Id.* at 7.

[184] *Id.* at 31 (describing the views of representatives from the International Monetary Fund).

[185] *Id.* at 22–33.

the advantage that, as long as the proper amount of tax has been withheld from wages and other income sources, no return has to be filed. Over 30 foreign countries use some form of final withholding. Table 12 shows how effective final withholding has been in four of these countries: Great Britain, Japan, Germany, and Argentina.[186]

Consider the vast majority of taxpayers whose earnings are virtually all from employment. Under final withholding, these employees provide their employers with Form W-4 type information like marital status and number of children. Then, depending upon the country, either the taxing authority or the employer determines how much tax to withhold. The employer periodically adjusts the amount withheld to ensure that the right amount is withheld by year's end. As the proper amount has been withheld, no return has to be filed.

TABLE 12. INTERNATIONAL FINAL WITHHOLDING SYSTEMS

Country	Tax year	Number of taxpayers eligible	Number of taxpayers who did not have to file
Great Britain	1991	26.0 million	23.0 million
Germany	1986	22.4 million	10.3 million
Japan	1988-90	46.0 million	29.0 million
Argentina	Mid-1980s	2.2 million	1.0 million

Source: OPPORTUNITIES TO REDUCE TAXPAYER BURDENS, *supra* note 73, at 36.

For example, in Great Britain, the income tax is deducted by employers under the British PAYE (Pay As You Earn) final withholding system.[187] When an individual first becomes potentially subject to tax, an initial tax return must be filed so that the Inland Revenue can determine how much the employer should withhold. Thereafter, individuals with simple incomes and modest earnings are normally required to make a return of income only about once every five years.[188] In 1991, for example, 23 million of the 26 million taxpayers eligible for PAYE did not file returns.[189]

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[186] *Id.* at 36.

[187] *See generally* J. A. KAY & M. A. KING, THE BRITISH TAX SYSTEM 49-50 (5th ed. 1990). Great Britain's tax system is often referred to as a "schedular system" because different tax schedules are used to report different kinds of income.

[188] The British system has flat tax rates over broad ranges on income, and the system credits the taxpayer each week with one-fifty-second of her annual personal allowances. Accordingly, it is relatively easy to ensure that the proper amount of tax has been paid at each point during the year. On the other hand, individuals need to advise the Inland

As for interest and dividends, some countries require financial institutions and other corporations to withhold taxes at a flat rate. Other countries instead require individuals to file a return to report passive income over some threshold. Recipients of other forms of passive investment income generally have to file returns, and there seems to be no getting around having self-employed individuals file returns.

Would a final withholding system work in the United States? A final withholding system could significantly reduce burdens on both individuals and the IRS. In its analysis of the issue, the General Accounting Office concluded that most taxpayers who now file 1040EZ returns (about 19 million in 1994) and many of those who now file 1040A returns (about 23 million in 1994) could be served by a final withholding system.[190] In a final withholding system, most of these people would no longer have to gather information, become familiar with tax laws, or prepare and file returns. The burden on the IRS would also be greatly reduced. Reconsideration of Table 7 provides a fairly good idea of the range of savings that could be expected from adopting a final withholding tax system.

On the other hand, participating taxpayers could no longer expect refunds each April; whereas now many taxpayers use refunds as a form of periodic savings.[191] Moreover, political opposition could be expected from financial institutions and other payers that would be required to withhold in an effective final withholding system, and from tax preparers who would lose much of their market. Finally, reducing the number of people who have to file federal income tax returns could adversely impact the 37 states that currently require taxpayers to use information from their federal returns to complete their state income tax returns.

V. CONCLUSION

Millions of Americans have no net federal tax liabilities, yet they are required to file income tax returns to recover refunds of their over-withheld taxes. Millions more have to keep records and file unnecessarily complicated tax returns to pay relatively little federal tax. This Article has considered a

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Revenue of changes in family situation (e.g., the individual marries) so that an individual's personal allowances can be changed. *Id.*

[189] *See* Table 12.

[190] *Selected IRS Data*, *supra* note 21, at 189; OPPORTUNITIES TO REDUCE TAXPAYER BURDENS, *supra* note 73, at 25.

[191] Employee privacy may also be a concern. For a final withholding system to work properly, the employer may need to know even more about the employee's income, family situation, and other jobs than under current law.

number of ways to restructure the federal tax system to help these low-income taxpayers and the IRS.

In many ways the federal tax system is at a crossroads. Will it move toward having virtually every individual file a tax return, or will it move in the opposite direction and reduce the number of individuals who must file returns? On the one hand, the repeated expansion of the earned income credit has obliged more and more individuals to file returns, if only to collect their earned income credit refunds. On the other hand, technological changes—like information reporting and electronic filing—could enable the federal tax system to move away from having so many individuals file returns. But whichever direction the tax system goes next, there will be opportunities to simplify the system for low-income taxpayers and for the IRS. It is the author's hope that the next round of tax reform will seize those opportunities.